CIMA P2 Advanced Management Accounting

Mock exam: 60 questions in 90 minutes, with an answer key and explanations

How to use this mock

- Set a timer for **90 minutes** and answer every question without notes. Write your answers in the grid on the next page.
- Mark your answers using the answer key, then read the explanation for every question you got wrong or guessed.
- The questions cover every section of the syllabus, in proportion to the GoQualified question bank for P2.
- Prefer to sit it on screen? The **Exam Sim** on **goqualified.co.uk/cima/p2/** times you, marks the paper and shows your weakest section.
- All questions are original GoQualified practice questions, not past exam questions.

Free from GoQualified. Questions start on page 3; the answer key and explanations follow them. Download the latest version from goqualified.co.uk/cima/p2/.

Your answers

1 _____	13 _____	25 _____	37 _____	49 _____
2 _____	14 _____	26 _____	38 _____	50 _____
3 _____	15 _____	27 _____	39 _____	51 _____
4 _____	16 _____	28 _____	40 _____	52 _____
5 _____	17 _____	29 _____	41 _____	53 _____
6 _____	18 _____	30 _____	42 _____	54 _____
7 _____	19 _____	31 _____	43 _____	55 _____
8 _____	20 _____	32 _____	44 _____	56 _____
9 _____	21 _____	33 _____	45 _____	57 _____
10 _____	22 _____	34 _____	46 _____	58 _____
11 _____	23 _____	35 _____	47 _____	59 _____
12 _____	24 _____	36 _____	48 _____	60 _____

Questions

Question 1

Which of the following best describes the key distinction between activity-based costing (ABC) and traditional absorption costing?

A ABC traces costs to products via the activities that drive them, while traditional absorption spreads overheads using a single volume-based rate
B ABC and traditional absorption always produce identical product costs regardless of the production mix
C Traditional absorption is always more accurate than ABC for all product types
D ABC eliminates all overhead costs and therefore always reduces total cost

Question 2

Which of the following is a key principle of just-in-time (JIT) inventory management?

A JIT requires maintaining the highest possible levels of raw material and finished goods inventory at all times
B JIT is applicable only to organisations with very long production cycles
C Materials and components are sourced and produced only as they are needed, eliminating the need for large buffer stocks
D JIT increases waste by ensuring that excess materials are always available on demand

Question 3

How does Kaizen costing differ from standard costing in its approach to cost management?

A Kaizen and standard costing are identical approaches with no meaningful distinction
B Kaizen targets continuous cost reduction below current actual cost; standard costing uses a fixed standard
C Standard costing always produces lower costs than Kaizen over time
D Kaizen ignores cost reduction and focuses solely on product quality

Question 4

A company has calculated a cost gap of £15 between the current estimated cost and the target cost of a new product. Which of the following is a recognised technique for closing this gap?

A Value engineering — redesigning the product to remove cost without reducing the value delivered to the customer
B Increasing the selling price until the gap disappears, regardless of market conditions
C Abandoning the product immediately, since no cost gap can ever be closed
D Accepting the current cost and eliminating the profit target entirely

Question 5

Under ABC, a company identifies that its quality inspection costs are driven primarily by the number of production batches, not by the volume of units produced. What implication does this have for how inspection costs should be assigned to products?

A Inspection costs should be assigned equally to all products regardless of how many batches each requires
B This finding has no implication for cost assignment, since all overheads must be volume-driven
C The company should discontinue all quality inspection to avoid the cost driver problem entirely
D Inspection costs should be assigned based on the number of batches each product type requires, rather than based on its share of total production volume

Question 6

A company uses cost-plus pricing to set the price of a new product, resulting in a price of £90. However, market research shows that customers will pay no more than £75 for an equivalent product. What does target costing suggest the company should do?

A Ignore market research and continue with the £90 price, since cost-plus pricing is always correct
B Work backwards from the £75 market price, set a target cost that allows the required profit margin, and redesign accordingly
C Reduce the required profit margin to zero so that the cost-plus price falls to £75
D Withdraw from the market immediately, since a price gap always means a product is unviable

Question 7

A manufacturer discovers that its high inbound logistics costs arise partly from unreliable supplier delivery, which also forces it to carry higher safety stocks. How does value chain analysis help explain why addressing supplier performance may reduce total cost?

A Value chain analysis shows that inbound logistics and inventory holding costs are always completely independent of one another

B Supplier performance only affects revenue, never internal costs

C Value chain analysis reveals linkages between activities — improving supplier delivery (inbound logistics) reduces both logistics costs and inventory holding costs downstream, demonstrating how activities are interdependent

D Addressing supplier performance would have no effect on the safety stock level required

Question 8

Research suggests that around 70–90% of a product's total life cycle costs are committed during the design phase, even though most costs are not incurred until later. What implication does this have for cost management?

A Since most costs are incurred during production, cost management should focus exclusively on the production phase

B Cost management effort is most effective early in the design phase, before costs are locked in, rather than focusing mainly on reducing costs during production

C Life cycle cost analysis is only relevant when the design and production phases occur simultaneously

D The design phase has no influence over costs incurred in the later stages of the product life cycle

Question 9

Why does a JIT production system place particularly high demands on supplier reliability?

A JIT maintains large safety stocks precisely to protect against unreliable suppliers

B Supplier reliability is irrelevant under JIT since production schedules never change

C Because there is no buffer stock to absorb late or defective deliveries, any supplier failure causes production to stop immediately

D JIT requires only one delivery per year from each supplier, making timing less critical

Question 10

In activity-based costing, what is a 'cost driver'?

A The total amount of overhead allocated to a product using a single absorption rate

B The standard labour hours expected to produce one unit of output

C The fixed overhead expenditure variance compared against the budgeted overhead

D The factor that causes an activity's costs to change, used to assign activity costs to products or services

Question 11

A company is trying to close a target cost gap through value engineering. Which of the following is a typical value engineering approach?

A Increasing the selling price until the cost gap disappears, regardless of the market price

B Reducing staff training to cut costs, even if this impairs quality

C Accepting the gap and reducing the profit target to maintain the current product design unchanged

D Reviewing component specifications to identify materials that deliver the same functional performance at lower cost

Question 12

A company using Kaizen costing sets a cost-reduction target of 2% below actual cost for the coming month. Actual cost is currently £200 per unit. What is the Kaizen target cost for the coming month?

A £196

B £204

C £160

D £200

Question 13

How does value chain analysis extend beyond the boundaries of a single organisation to consider 'external linkages'?

A Analysis is strictly limited to activities within the organisation's own legal entity
B All costs incurred by suppliers are irrelevant to the organisation's cost management
C The organisation's position depends on its own activities and also on its suppliers and customers in the wider value system
D The value chain ends at the point the product leaves the organisation's own production facility

Question 14

Which of the following costs should be included as a relevant cash flow when appraising a new capital investment project?

A The sunk cost of market research already completed before the investment decision
B The depreciation charge that will be recorded on the new asset each year
C The apportioned share of existing head-office overhead that will not change in total
D The incremental annual operating costs that will be incurred only if the project proceeds

Question 15

A project requires an initial working capital investment of £30,000 at time 0. At the end of year 3, when the project closes, all working capital is recovered. The company's discount rate is 10%. What is the net present value impact of the working capital flows? PV factor at 10% year 3 = 0.751.

A −£30,000
B −£22,530
C −£7,470
D £7,470

Question 16

Which of the following is a recognised limitation of accounting rate of return (ARR) as a capital investment appraisal technique?

A ARR is the only technique that correctly accounts for the time value of money
B ARR is identical to NPV in all situations and always gives the same investment decision
C ARR always ranks projects correctly under capital rationing conditions
D ARR uses accounting profit rather than cash flows, and ignores the time value of money

Question 17

A company launches a new product at a deliberately low initial price to build market share quickly, intending to raise prices later once volume is established. Which pricing strategy does this describe?

A Price skimming
B Premium pricing
C Penetration pricing
D Loss-leader pricing

Question 18

Which of the following is a recognised limitation of payback period as a capital investment appraisal technique?

A Payback is the only technique that correctly measures the total return generated over a project's full life
B It ignores cash flows that occur after the payback period has been reached, and makes no adjustment for the time value of money
C Payback always gives the same accept or reject decision as NPV
D Payback period accounts for the time value of money through its discounting mechanism

Question 19

A project has an NPV of £5,000. The PV of the project's annual labour cost cash flows is £30,000. What is the sensitivity margin for labour costs, and what does it mean?

A 5.0% — labour costs can fall by 5.0% before the project becomes unacceptable
B 16.7% — labour costs must fall by 16.7% for the NPV to become positive
C 16.7% — labour costs can rise by 16.7% before the NPV falls to zero
D 83.3% — this is the proportion of total cash flows attributable to labour

Question 20

A project generates equal after-tax operating cash flows of £60,000 per year for 5 years. The initial investment is £200,000 and the discount rate is 10%. The 5-year annuity factor at 10% is 3.791. What is the NPV?

A £27,460
B £100,000
C −£27,460
D £60,000

Question 21

An asset costing £120,000 attracts a 25% reducing-balance writing-down allowance. Tax is 25% and payable one year in arrears. What is the tax saving from the year 2 writing-down allowance, and in which year is it received?

A £5,625 received in year 2
B £5,625 received in year 3
C £22,500 received in year 3
D £7,500 received in year 2

Question 22

A company spent £15,000 on a market study 6 months ago when evaluating a new project. The study has now been completed and its results are available. Should the £15,000 be included in the project appraisal?

A Yes — all costs associated with a project must be included, regardless of when they were incurred
B Yes — past costs always influence future decisions under discounted cash flow principles
C No — it is a sunk cost, already incurred and irreversible, so it is not relevant to the future investment decision
D No — only variable costs are ever relevant to project appraisals

Question 23

Why is net present value (NPV) generally considered the theoretically superior capital investment appraisal technique compared with ARR and payback?

A ARR is always more accurate than NPV because it uses actual accounting profits
B Payback is superior since it considers cash flows beyond the payback cut-off date
C NPV and ARR always give the same accept or reject decision
D NPV discounts all cash flows over the full life, measures time value and change in shareholder wealth

Question 24

A project has a base-case NPV of −£50,000, which would normally make it unacceptable. However, the company retains the right to abandon the project after year 1 if early results are disappointing. How should the existence of this abandonment option affect the investment decision?

A The abandonment option may still make the project worth undertaking if its value (the protection it provides against further losses) exceeds the negative base-case NPV
B A negative base-case NPV can never be overcome by any real option, so the project must be rejected
C The option to abandon has no value since abandoning a project always incurs greater costs than continuing
D Real options only add value when the base-case NPV is already positive

Question 25

A company has a factory manager on a salary of £60,000 per year. The factory manager's time will be partially used on a new project, but their total salary will remain unchanged. Should the £60,000 salary be included as a relevant cost of the project?

A Yes — the factory manager's salary is an opportunity cost and must be included
B Yes — all fixed costs must always be included as relevant costs in project appraisals
C Yes — employee costs are always relevant regardless of whether the total changes
D No — the salary is a committed fixed cost that will not change as a result of the project decision, so it is irrelevant

Question 26

The first unit of a product takes 160 hours and labour costs £20 per hour. An 80% learning curve applies. What is the expected total labour cost for the first 4 units?

A £12,800
B £5,120
C £8,192
D £6,400

Question 27

A company uses a machine that has spare capacity. The variable cost of running the machine is £8 per hour. A new project would use 100 hours of this machine. The fixed overhead absorption rate for the machine is £15 per hour. What is the relevant cost of the machine time for the project?

A £2,300 — the full absorption cost of 100 hours at £23
B £1,500 — only the fixed overhead charge
C £0 — machine time is already owned and has no relevant cost
D £800 — only the variable cost of 100 hours, since fixed costs do not change

Question 28

A company evaluates a special order for 500 units at £30 per unit. Existing sales are unaffected. Variable cost is £22 per unit; fixed overhead absorption is £8 per unit. Should the order be accepted on purely financial grounds?

A Yes — contribution of £8 per unit (£30 − £22) gives positive incremental cash flow
B No — the price does not cover the full absorbed cost of £30 per unit
C No — special orders should never be accepted below full cost price
D Yes — but only if variable and fixed costs together are below the price

Question 29

A technology company launches a product at £600, targeting early adopters, and plans staged price reductions as competitors enter. Which pricing strategy is this?

A Penetration pricing — a low entry price to build market share quickly
B Price skimming — extracting maximum value from early adopters before lowering prices as competition grows
C Cost-plus pricing — adding a margin to the full production cost
D Premium pricing — a permanently high price signalling exclusivity

Question 30

Material costs inflate at 6% per year; general inflation is 4%. A nominal discount rate is used. How should material cost cash flows be treated?

A Inflate at 4% general inflation since specific rates are ignored
B Express in real terms and discount at the nominal rate directly
C Inflate all costs at the nominal discount rate
D Inflate at 6% per year (the specific rate) then discount at the nominal rate

Question 31

A project has an NPV of £12,000 and an initial investment of £80,000. What is the sensitivity of the NPV to the initial investment?

A 8%
B 12%
C 6.7%
D 15%

Question 32

A factory runs at full capacity. A new contract needs 200 machine hours currently used on existing work generating £15 contribution per hour. What is the opportunity cost of the machine hours?

A £3,000 — contribution foregone on displaced existing production
B £0 — existing work is sunk
C £15 — only one hour's contribution
D The fixed overhead rate × 200 hours

Question 33

A project costs £200,000 (no scrap). Average annual profit over 5 years is £30,000. What is the ARR on average investment?

A 15%
B 6.7%
C 3%
D 30%

Question 34

A project costs £120,000. Inflows: year 1 £30,000, year 2 £50,000, year 3 £60,000. What is the payback period?

A 2 years exactly
B 2 years 8 months
C 3 years exactly
D 1 year 6 months

Question 35

Division S sells a component both externally and to Division B. Division S has no spare capacity — every unit sold internally displaces an external sale. Variable cost per unit is £40, external market price is £70. What is the minimum transfer price Division S should accept?

A £40, since only variable cost needs to be covered when there is spare capacity
B £70, since Division S must recover its variable cost plus the contribution it foregoes on lost external sales
C £55, which is the midpoint between variable cost and market price
D £0, since internal transfers should always be free of charge

Question 36

A retailer compares its stock-turn ratio with the best-performing retailer in its sector, even though that company is a direct competitor and no data is formally shared. Which type of benchmarking does this represent?

A Internal benchmarking, comparing performance across different divisions of the same company
B Functional benchmarking, comparing a specific process against a world-class organisation outside the sector
C Collaborative benchmarking, where organisations share internal data with each other by mutual agreement
D Competitive benchmarking, using publicly available data to compare performance against direct competitors

Question 37

Which of the following is an example of a non-financial performance indicator that might appear in the customer perspective of a balanced scorecard?

A Net profit margin expressed as a percentage of total revenue
B Return on capital employed for the current financial year
C Earnings per share compared against the prior year
D Customer satisfaction score derived from regular survey data

Question 38

What does goal congruence mean in divisional performance measurement?

A Managers always deliberately make decisions that harm the organisation
B Managers' personal objectives align with organisational objectives, so their decisions benefit both simultaneously
C Goal congruence applies only when all divisions are identical in size and focus
D It is achieved automatically once budgets are set for every division

Question 39

A division reports operating profit of £180,000. Its net assets are £1,500,000 and the company's cost of capital is 10%. What is the residual income?

A £180,000
B £30,000
C £150,000
D −£30,000

Question 40

Why does residual income typically lead to better goal congruence than return on investment when appraising new divisional investments?

A RI and ROI always produce the same investment decisions, so there is no difference in goal congruence
B ROI produces better goal congruence because it measures the percentage return available to shareholders
C RI credits any return above the cost of capital as positive, so managers accept value-creating projects that ROI would cause them to reject
D RI encourages managers to maximise the size of their asset base regardless of the return earned on it

Question 41

A division budgeted total contribution of £200,000 and achieved actual contribution of £185,000. What is the contribution variance, and is it favourable or adverse?

A £15,000 adverse
B £15,000 favourable
C £200,000 adverse
D £185,000 favourable

Question 42

When would a market-based transfer price be considered the most appropriate basis for setting an internal transfer price?

A When there is no external market for the transferred product, since market-based pricing requires only theoretical market data
B When the internal transfer must be made at the lowest possible price to reduce the buying division's costs
C When tax considerations require the transfer price to be set as high as possible to shift profit between jurisdictions
D When an active external market exists for the transferred product, making the market price a fair and objective benchmark that reflects the economic value of the transfer

Question 43

Division X, in Country X (30% tax), sells to Division Y, in Country Y (10% tax). In which direction would the group prefer to shift profit through the transfer price to minimise total tax?

A Towards Country X — a high transfer price benefits the group since X has the lower rate
B Neither direction — group profit is unaffected by transfer price
C Towards whichever division has the higher sales, since tax rates do not affect the choice
D Towards Country Y — low transfer price reduces high-tax X profit, increases low-tax Y profit

Question 44

A cost centre manager controls costs but not revenues. What performance measure is most appropriate?

A Return on capital employed
B Revenue growth versus prior year
C Cost variances against budget, focusing on controllable cost efficiency
D Net profit margin on the department's revenues

Question 45

Average training days per employee sits in which balanced scorecard perspective?

A Customer — measures service experience
B Financial — measures cost efficiency
C Internal business process — measures production efficiency
D Learning and growth — reflects investment in employee capability

Question 46

Division S produces a component at variable cost £30. Division B incorporates it into a product sold externally for £90, incurring further variable costs of £45 beyond the transfer price. What is the maximum transfer price Division B would accept?

A £45 — where B's contribution falls to zero
B £30 — Division S's variable cost
C £90 — the final external selling price
D £15 — group contribution per unit

Question 47

A division reports operating profit of £240,000 and net assets of £1,600,000. What is the return on investment?

A 6.7%
B 15%
C 24%
D 12%

Question 48

The same division from the previous question (operating profit £240,000, net assets £1,600,000) has a company cost of capital of 12%. What is the residual income?

A £240,000
B £192,000
C £48,000
D −£48,000

Question 49

A divisional profit report includes a share of head-office costs allocated on the basis of divisional revenue. The divisional manager has no influence over either the total head-office cost or the allocation method. Why should this allocated cost be excluded from the assessment of the manager's performance?

A Because head-office costs are never real costs and should be ignored in all performance reports
B Because allocated costs are always zero and have no financial impact on reported profit
C Because divisional managers should never be provided with any overhead cost information
D Because including uncontrollable costs makes the assessment unfair and can demotivate the manager by holding them responsible for decisions made elsewhere

Question 50

A company notices that improved employee training scores (learning and growth perspective) lead to lower defect rates (internal process perspective), which in turn lead to higher customer satisfaction (customer perspective), which eventually drives revenue growth (financial perspective). What does this chain illustrate about the balanced scorecard?

A Each of the four perspectives operates entirely independently, with no relationship between them
B The financial perspective is irrelevant since it simply reflects the other three
C Cause-and-effect chains in the BSC run from financial to non-financial, not the other way
D The BSC is built on cause-and-effect linkages between the four perspectives, so non-financial improvements ultimately drive financial outcomes

Question 51

Economic Value Added (EVA) is sometimes used as an alternative to residual income for measuring divisional performance. What is the key idea behind EVA?

A It measures divisional profit purely as a percentage return on capital employed, exactly like ROI
B It ignores the cost of capital entirely and focuses only on absolute profit growth
C It is calculated identically to residual income with no adjustments of any kind, simply under a different name
D It adjusts accounting profit and capital for a range of distortions (such as capitalising rather than expensing certain costs) to better approximate economic profit, then deducts a capital charge based on the adjusted capital employed

Question 52

When using the rollback method to evaluate a decision tree, in what order are the calculations performed?

A Starting from the rightmost outcomes and working backwards, calculating expected values at chance nodes and taking the best option at decision nodes
B Starting from the leftmost decision node and working forwards, taking the highest-value branch at each stage
C Calculating every possible path's total value and selecting the one with the highest single outcome
D Ignoring probability-weighted calculations and selecting the strategy with the minimum possible loss at each stage

Question 53

Which of the following correctly identifies all four risk responses in the TARA framework?

A Transfer, Analyse, Reduce, and Assess
B Transfer, Avoid, Reduce, and Accept
C Tolerate, Accept, Reduce, and Avoid
D Transfer, Avoid, Retain, and Assess

Question 54

A company identifies a risk of flooding at a storage facility, which has a high potential impact but a low probability. The company decides to take out insurance against the financial loss. Which TARA response does this represent?

A Avoid — the company ceases the storage activity to remove the risk entirely
B Reduce — the probability of flooding is lowered through preventive measures
C Transfer — the financial consequences of the risk are passed to an insurer
D Accept — the company decides to do nothing and absorb any loss itself

Question 55

Why are professional accountants expected to act in the public interest, rather than solely in the interests of their employer or client?

A Because the accounting profession's role in providing credible financial information underpins public trust in capital markets and the wider economy
B Because acting in the public interest always increases an employer's short-term profit
C Because regulatory requirements mandate that accountants prioritise public interest only in audit engagements
D Because the concept of public interest is purely aspirational and has no practical consequence for any real decision

Question 56

How does sensitivity analysis differ from expected value analysis in the way it handles uncertainty in a capital investment appraisal?

A They are identical techniques that always give the same result
B Sensitivity shows how much a variable can change before the decision reverses, without probabilities; EV weights outcomes by probability
C EV examines one variable at a time; sensitivity needs probability estimates for every outcome
D Sensitivity eliminates uncertainty by fixing all variables at their most likely value

Question 57

Which of the following is a recognised limitation of using expected monetary value (EMV) as the sole criterion for decision-making under risk?

A EMV is too complicated to calculate for most business decisions
B It ignores outcome variance, so risk attitude and extreme losses are not reflected
C EMV always produces the same result regardless of probabilities assigned
D EMV only applies when there are exactly two possible outcomes

Question 58

A management accountant is pressured by a senior manager to alter a divisional performance report to show a higher profit, against the accountant's professional judgement. What is the appropriate first step for the accountant?

A Comply immediately, since following a manager's instruction is always the professional obligation
B Alter the figures but add an undisclosed footnote
C Refuse and raise the matter through appropriate internal channels such as a more senior manager or audit committee
D Resign immediately without first attempting internal resolution

Question 59

A project has an NPV of £8,000. The PV of the project's total contribution over its life is £64,000. What is the sensitivity of the NPV to the contribution margin?

A 8.0%
B 6.25%
C 12.5%
D 64.0%

Question 60

A company identifies that a new regulation is likely to create a significant demand surge for its products. It decides to increase production capacity in advance of the regulation taking effect. Which risk management concept does this illustrate?

A Managing downside risk — mitigating the negative consequences of the regulation
B Managing upside risk — proactively positioning to exploit a positive uncertainty before it materialises
C Risk acceptance — absorbing the consequences of the new regulation without any response
D Risk transfer — passing the financial consequences of the regulation to another party

Answer key

1 A	**13** C	**25** D	**37** D	**49** D
2 C	**14** D	**26** C	**38** B	**50** D
3 B	**15** C	**27** D	**39** B	**51** D
4 A	**16** D	**28** A	**40** C	**52** A
5 D	**17** C	**29** B	**41** A	**53** B
6 B	**18** B	**30** D	**42** D	**54** C
7 C	**19** C	**31** D	**43** D	**55** A
8 B	**20** A	**32** A	**44** C	**56** B
9 C	**21** B	**33** D	**45** D	**57** B
10 D	**22** C	**34** B	**46** A	**58** C
11 D	**23** D	**35** B	**47** B	**59** C
12 A	**24** A	**36** D	**48** C	**60** B

Score: count your correct answers out of 60. Then work through the explanations below.

Answers and explanations

Question 1: A ABC traces costs to products via the activities that drive them, while traditional absorption spreads overheads using a single volume-based rate

The key distinction is that ABC traces overhead costs to products via the specific activities that drive those costs — using multiple cost drivers — whereas traditional absorption costing spreads overheads across products using a single volume-based rate (such as labour hours or machine hours). This means the two methods can produce materially different product costs, particularly where the production mix is varied and overheads are not truly volume-driven. ABC does not eliminate overheads; it reallocates them more precisely, and neither system is universally more accurate for every product type.

Section A, Activity-based costing vs traditional absorption · Ref A1a · p2001

Question 2: C Materials and components are sourced and produced only as they are needed, eliminating the need for large buffer stocks

JIT operates on the principle of producing and procuring materials only as and when they are needed, which eliminates the need for large buffer stocks and the holding costs associated with them. This requires reliable supplier relationships and predictable demand patterns to work effectively. JIT is the opposite of maintaining high inventory levels, and it actually aims to reduce waste — excess inventory is itself considered a form of waste under JIT philosophy. It is applicable across a range of organisations and production settings, not limited to any particular cycle length.

Section A, JIT and inventory management · Ref A1b · p2003

Question 3: B Kaizen targets continuous cost reduction below current actual cost; standard costing uses a fixed standard

Kaizen costing sets an ongoing target of continuous, incremental cost reduction below the current actual cost level, building the expectation of improvement into the cost management process. Standard costing, by contrast, compares actual costs against a fixed predetermined standard that may remain unchanged for a period. The two approaches are genuinely distinct: Kaizen embeds the expectation of improvement whereas standard costing typically embeds the expectation of consistency. Kaizen encompasses cost reduction as a key objective alongside quality, and standard costing does not inherently produce lower costs than Kaizen over time.

Section A, Kaizen costing and continuous improvement · Ref A1b · p2006

Question 4: A Value engineering — redesigning the product to remove cost without reducing the value delivered to the customer

Value engineering is a key technique for closing a target cost gap — it involves analysing the product's design and components to find ways to reduce cost without reducing the value or functionality that customers actually need. Increasing the selling price is not always feasible in a competitive market, which is precisely why target costing works backwards from the market price rather than adding on the current cost. A cost gap does not automatically make a product unviable — it is an invitation to improve the design or process. Eliminating the profit target defeats the entire purpose of target costing as a technique.

Section A, Target costing — closing the gap · Ref A1c · p2009

Question 5: D Inspection costs should be assigned based on the number of batches each product type requires, rather than based on its share of total production volume

If inspection costs are driven by the number of batches rather than production volume, assigning them using a volume-based rate (such as per unit produced) will systematically undercharge high-batch, low-volume products and overcharge low-batch, high-volume products. ABC specifically addresses this by assigning inspection costs based on the actual cost driver — batches — giving a more accurate product cost. Assigning costs equally regardless of driver consumption ignores this insight entirely, and overheads need not all be volume-driven — recognising batch-level drivers is precisely what ABC is designed to do. Stopping inspection to avoid the problem would sacrifice quality control rather than solve the costing issue.

Section A, ABC cost driver selection · Ref A1a · p2012

Question 6: B Work backwards from the £75 market price, set a target cost that allows the required profit margin, and redesign accordingly

Target costing starts from the market price that customers will actually pay — here £75 — deducts the required profit margin to arrive at the target cost, and then drives product design and engineering efforts to meet that target cost. This is the opposite of cost-plus pricing, which adds a margin to the current cost regardless of what the market will bear. Reducing the profit margin to zero would undermine the commercial case for the product, and a price gap does not necessarily mean the product is unviable — it means the design or cost structure needs to change, which is exactly what target costing is designed to prompt.

Section A, Target costing and market orientation · Ref A1c · p2014

Question 7: C Value chain analysis reveals linkages between activities — improving supplier delivery (inbound logistics) reduces both logistics costs and inventory holding costs downstream, demonstrating how activities are interdependent

Value chain analysis explicitly considers linkages between activities, not just the cost of each activity in isolation — improving supplier delivery reliability (an inbound logistics improvement) reduces the uncertainty that forces the company to hold higher safety stocks, which in turn reduces inventory holding costs. These are interdependent activities, not independent ones, and value chain analysis is specifically designed to surface these cross-activity linkages. Supplier performance clearly affects internal costs by driving safety stock requirements, so both the logistics cost and the holding cost can be reduced together by addressing the root cause.

Section A, Linkages in the value chain · Ref A1d · p2015

Question 8: B Cost management effort is most effective early in the design phase, before costs are locked in, rather than focusing mainly on reducing costs during production

If the great majority of a product's life cycle costs are committed (i.e. determined by decisions made) during design — even though cash is not yet spent — then cost management effort focused at that early stage has the greatest leverage. By the time the product reaches production, most cost-reduction opportunities have already been foreclosed by design choices already made. This is the central insight behind target costing and life cycle costing: cost must be managed upstream. The production phase still deserves attention, but the marginal impact of cost management there is smaller once design decisions have been made.

Section A, Life cycle cost profile — design phase · Ref A1e · p2062

Question 9: C Because there is no buffer stock to absorb late or defective deliveries, any supplier failure causes production to stop immediately

JIT holds little or no buffer stock, so production depends directly on materials arriving on time and in the right quality exactly when needed. Any supplier failure — late delivery or defective materials — immediately halts production, with no safety stock to absorb the disruption. This is why strong, long-term supplier partnerships are essential for JIT to work. Maintaining large safety stocks is the opposite of JIT philosophy, and supplier reliability is critical because production schedules are tightly synchronised with delivery schedules, not insulated from them.

Section A, JIT and supplier relationships · Ref A1b · p2063

Question 10: D The factor that causes an activity's costs to change, used to assign activity costs to products or services

A cost driver in ABC is the factor that causes the cost of a specific activity to vary — for example, the number of purchase orders drives procurement costs, or the number of quality inspections drives quality control costs. Activity costs are assigned to products in proportion to their consumption of the cost driver. This is more accurate than using a single volume-based absorption rate, since it reflects the actual relationship between activities and their costs. Labour hours describe a traditional absorption cost driver, not the ABC concept, and fixed overhead variances are a standard costing concept entirely separate from ABC.

Section A, ABC — cost pool and cost driver · Ref A1a · p2064

Question 11: D Reviewing component specifications to identify materials that deliver the same functional performance at lower cost

Value engineering involves analysing the product's design, components and processes to identify changes that preserve or maintain the same functional value for the customer at a lower cost — for example, substituting a less expensive material that performs identically, or redesigning a component to require fewer parts. Raising the selling price ignores the market constraint that makes target costing necessary in the first place. Cutting staff training risks quality failures that generate costs of their own, and accepting the gap by reducing the profit target defeats the purpose of target costing as a market-driven cost management discipline.

Section A, Target costing — implementation strategies · Ref A1c · p2068

Question 12: A £196

Kaizen target cost = current actual cost × (1 − reduction rate) = £200 × (1 − 0.02) = £200 × 0.98 = £196. The reduction is applied to actual current cost, not a fixed standard — this reflects Kaizen's philosophy of continuous improvement beyond the current position rather than meeting a fixed historical standard. £204 would be a cost increase, which reverses the direction. £160 might arise from misapplying a 20% reduction rather than 2%. £200 is the current cost with no reduction applied, which represents no improvement at all.

Section A, Kaizen — incremental improvement targets · Ref A1b · p2069

Question 13: C The organisation's position depends on its own activities and also on its suppliers and customers in the wider value system

Value chain analysis can be extended to consider the wider value system — the linked value chains of suppliers, the organisation itself, distributors and customers. Recognising these external linkages helps identify how supplier performance, upstream costs and customer requirements affect the organisation's own competitive position, and where opportunities for joint cost reduction or value enhancement may exist across organisational boundaries. Limiting analysis to the single legal entity misses this broader perspective entirely, and treating supplier costs as irrelevant contradicts the purpose of identifying external linkages. The value delivered to the end customer is shaped by activities far beyond the organisation's own production facility.

Section A, Value chain — supplier linkages · Ref A1d · p2071

Question 14: D The incremental annual operating costs that will be incurred only if the project proceeds

Relevant cash flows are those that are incremental — occurring only if the project proceeds — and are actual future cash flows. Incremental annual operating costs meet both criteria and are therefore included. Sunk costs such as past market research spending are irrecoverable regardless of the decision and are excluded. Depreciation is a non-cash accounting charge, not a cash flow, so it is excluded from DCF analysis (though the tax effect of capital allowances may be included separately). Apportioned shares of overhead that do not change in total are not incremental and are therefore irrelevant to the investment decision.

Section B, Relevant cash flows for investment appraisal · Ref B1a · p2016

Question 15: C −£7,470

Working capital outflow at time 0: −£30,000 (already in present value terms). Working capital recovery at end of year 3: +£30,000 × 0.751 = +£22,530. Net PV impact = −£30,000 + £22,530 = −£7,470. The net cost reflects the time value of money — the recovery is worth less than the initial outlay because it occurs later. A common error is to assume working capital nets to zero (ignoring discounting), or to forget that the recovery occurs at project end. The outflow at time 0 requires no discounting since it is already at present value.

Section B, NPV calculation with working capital · Ref B1b · p2019

Question 16: D ARR uses accounting profit rather than cash flows, and ignores the time value of money

A fundamental limitation of ARR is that it is based on accounting profit — which includes non-cash items such as depreciation — rather than actual cash flows, and it takes no account of the time value of money, treating a profit earned in year 5 as equivalent in value to one earned in year 1. In contrast, NPV explicitly discounts future cash flows to present value, reflecting their true worth today. ARR does not consider time value of money at all, which can lead to different and potentially inferior investment decisions compared with NPV, and it does not always rank projects correctly under capital rationing.

Section B, ARR as an investment appraisal technique · Ref B1e · p2024

Question 17: C Penetration pricing

Setting a deliberately low initial price to build market share rapidly, with the intention of raising prices later, is the defining feature of penetration pricing. Price skimming is the opposite approach — setting a high initial price to exploit early adopters' willingness to pay and gradually reducing it as competitors enter. Premium pricing maintains a consistently high price to signal quality and exclusivity, with no intention of reducing it as volume grows. Loss-leader pricing sells a specific item below cost to drive traffic that generates profit elsewhere, which is different from penetration pricing's market-share-building rationale.

Section B, Penetration and skimming pricing strategy · Ref B1f · p2027

Question 18: B It ignores cash flows that occur after the payback period has been reached, and makes no adjustment for the time value of money

Two fundamental limitations of payback are that it ignores all cash flows occurring after the payback cut-off date (which may be the most profitable period of the project) and that it makes no adjustment for the time value of money — a cash inflow in year 3 is treated identically to one received in year 1. Payback measures the speed of cost recovery, not the total return over a project's life — making it a poor substitute for NPV or IRR when total value creation matters. Discounted payback addresses the time-value limitation but standard payback does not discount cash flows at all.

Section B, Payback period — limitation · Ref B1e · p2030

Question 19: C 16.7% — labour costs can rise by 16.7% before the NPV falls to zero

Sensitivity margin = NPV ÷ PV of the variable = £5,000 ÷ £30,000 = 16.67%, rounded to 16.7%. This means that if labour costs increase by 16.7% (i.e. the PV of labour costs rises by £5,000), the NPV falls exactly to zero — any larger increase would make the project unacceptable. The variable with the smallest sensitivity margin is the most sensitive, since it takes the smallest adverse change to destroy project value. The 83.3% figure is the complement (1 − 16.7%) and does not have the stated meaning; the 5.0% and direction-reversed interpretations are also incorrect.

Section B, Sensitivity analysis · Ref B1e · p2035

Question 20: A £27,460

PV of annuity = £60,000 × 3.791 = £227,460. NPV = PV of inflows − initial investment = £227,460 − £200,000 = £27,460. The positive NPV indicates the project earns more than the required 10% return and should be accepted. Ignoring discounting (£60,000 × 5 = £300,000, less £200,000) gives the £100,000 option. The −£27,460 option reverses the sign by subtracting the PV of inflows from the investment. £60,000 is just one year's cash flow.

Section B, Annuity — project NPV · Ref B1c · p2077

Question 21: B £5,625 received in year 3

Year 1 TWDV: £120,000 − (£120,000 × 25%) = £120,000 − £30,000 = £90,000. Year 2 WDA: £90,000 × 25% = £22,500. Tax saving: £22,500 × 25% = £5,625. Since tax is payable one year in arrears, the saving from the year 2 allowance reduces the year 3 tax bill — i.e., it is received in year 3. A common error is to report the WDA itself (£22,500) rather than the tax saving on it. Another is to assume the saving is received in the same year (year 2). The time-lag is critical in getting the correct year of cash benefit. £7,500 is the tax saving on the year 1 allowance (£30,000 × 25%), which is received in year 2, but the question asks about the year 2 allowance.

Section B, Capital allowances — year 2 tax saving · Ref B1b · p2078

Question 22: C No — it is a sunk cost, already incurred and irreversible, so it is not relevant to the future investment decision

The £15,000 market study cost has already been incurred and cannot be recovered regardless of whether the project proceeds or not — it is a sunk cost, which is irrelevant to the forward-looking investment decision. DCF analysis is based on future, incremental cash flows, not past expenditure. Including sunk costs in an appraisal would lead to keeping bad investments simply because money has already been spent on them. The relevant cost principle requires including only costs that will actually change as a result of the decision — sunk costs, by definition, will not change.

Section B, Relevant cost — sunk vs future · Ref B1a · p2079

Question 23: D NPV discounts all cash flows over the full life, measures time value and change in shareholder wealth

NPV is theoretically superior because it uses cash flows (not accounting profits), considers all cash flows across the full project life (not just up to a cut-off date), applies discounting to reflect the time value of money, and directly measures the expected increase in shareholder wealth in present-value terms. ARR uses accounting profit rather than cash flows and ignores the time value of money — both significant limitations. Payback ignores all cash flows after the cut-off date and similarly makes no time-value adjustment. NPV and ARR can and do give different decisions, which is precisely why the choice of technique matters.

Section B, NPV superiority as a decision technique · Ref B1e · p2080

Question 24: A The abandonment option may still make the project worth undertaking if its value (the protection it provides against further losses) exceeds the negative base-case NPV

A real option such as the right to abandon can add value precisely because it limits downside risk — if year 1 results are poor, the company can cut losses by abandoning rather than continuing. If the value of this option (the potential losses avoided) exceeds the negative base-case NPV, the overall project value may be positive. Negative base-case NPVs do not automatically make a project unacceptable once optionality is factored in. The option to abandon does have value if it genuinely reduces potential downside, and real options can add value regardless of whether the base NPV is positive or negative.

Section B, Real options — option to abandon · Ref B1d · p2081

Question 25: D No — the salary is a committed fixed cost that will not change as a result of the project decision, so it is irrelevant

The factory manager's salary will not change in total regardless of whether the project proceeds — it is a committed fixed cost. Since there is no incremental cash flow arising from this decision, the salary is not a relevant cost. An opportunity cost arises only if using the manager's time on the project means they cannot perform some other activity that has economic value — if they have spare time or the project fills otherwise idle time, there is no opportunity cost. The relevant cost principle excludes costs that do not change as a result of the decision, regardless of whether they are fixed or variable.

Section B, Relevant cost — committed fixed cost · Ref B1a · p2084

Question 26: C £8,192

Using the 80% learning curve: cumulative average time per unit after 2 units = 160 × 0.80 = 128 hours; after 4 units = 128 × 0.80 = 102.4 hours. Total time for 4 units = 4 × 102.4 = 409.6 hours. Total labour cost = 409.6 × £20 = £8,192. A common error is to multiply the first unit time by 4 with no learning applied: 160 × 4 × £20 = £12,800. £5,120 is the total for the first two units only (2 × 128 hours × £20), and £6,400 doubles the first unit's time (2 × 160 hours × £20); neither covers four units on the curve.

Section B, Learning curve — unit cost implication · Ref B1e · p2087

Question 27: D £800 — only the variable cost of 100 hours, since fixed costs do not change

With spare capacity, using the machine for the project incurs only the incremental variable cost: 100 hours × £8 = £800. There is no opportunity cost because the spare capacity has no alternative use. The fixed overhead absorption rate (£15 per hour) represents a charge for overheads that will be incurred regardless of this project — they are not incremental, so they are irrelevant. The full absorption cost (£23 per hour) incorrectly includes this non-incremental fixed cost. The relevant cost is not zero — the variable cost of running the machine does change as a result of the decision.

Section B, Relevant cost — spare capacity vs full capacity · Ref B1a · p2088

Question 28: A Yes — contribution of £8 per unit (£30 − £22) gives positive incremental cash flow

For a special order that does not affect existing business, only incremental costs matter. Contribution = £30 − £22 = £8 per unit. Fixed overhead (£8) is not incremental — it is incurred regardless — so the total absorbed cost (£30) is misleading. The order generates £8 × 500 = £4,000 incremental profit and should be accepted. Rejecting because absorbed cost equals price is a common error that treats non-incremental fixed costs as though they change with the decision.

Section B, Relevant cost — special order decision · Ref B1a · p2089

Question 29: B Price skimming — extracting maximum value from early adopters before lowering prices as competition grows

Launching at a high price to capture early adopters and then reducing as competition grows is price skimming. Penetration pricing is the opposite — deliberately low initial pricing to build volume. Cost-plus sets price from cost up, unrelated to staged reductions. Premium pricing maintains permanently high pricing rather than reducing price over time.

Section B, Price skimming strategy · Ref B1f · p2090

Question 30: D Inflate at 6% per year (the specific rate) then discount at the nominal rate

In a nominal DCF, each cash flow is inflated at its own specific rate to produce money-term figures, then discounted at the nominal rate. Material costs inflate at 6%, so that specific rate applies — using the general 4% rate would understate material costs in later years. General inflation is used to build the nominal rate (via Fisher formula), not to inflate individual cash flow lines. Expressing costs in real terms and then discounting at a nominal rate mixes two different bases.

Section B, Specific vs general inflation in DCF · Ref B1b · p2092

Question 31: D 15%

Sensitivity = NPV ÷ PV of the variable = £12,000 ÷ £80,000 = 0.15 = 15%. The initial investment can rise by 15% before NPV reaches zero. A common error divides investment by NPV (£80,000 ÷ £12,000 = 6.7), which has no useful sensitivity interpretation. The variable with the smallest sensitivity margin is the most sensitive, since it takes the smallest adverse change to eliminate project value. 12% reads the £12,000 NPV as a percentage, and 8% does not follow from the figures.

Section B, Sensitivity — initial investment · Ref B1e · p2116

Question 32: A £3,000 — contribution foregone on displaced existing production

At full capacity, 200 hours used on the new contract displaces existing production, sacrificing £15 × 200 = £3,000 contribution. This is the opportunity cost — a real economic sacrifice included as a relevant cost. It is not sunk; the forgone contribution is a future cash flow. Fixed overhead absorption is non-incremental and not the correct measure here.

Section B, Relevant cost — lost contribution at full capacity · Ref B1a · p2117

Question 33: D 30%

Average investment = £200,000 ÷ 2 = £100,000. ARR = £30,000 ÷ £100,000 = 30%. Using full initial investment as denominator gives 15% — a common error. Dividing £200,000 ÷ £30,000 gives 6.7, not a meaningful ARR figure. This halving convention (average investment = initial ÷ 2 when there is no residual value) is the standard ARR formula for the average investment basis. 3% does not follow from the figures.

Section B, ARR — average investment basis · Ref B1e · p2120

Question 34: B 2 years 8 months

Cumulative after year 1: £30,000. After year 2: £80,000. Remaining: £120,000 − £80,000 = £40,000. Year 3 recovers £40,000 ÷ £60,000 = 0.667 years = 8 months. Payback = 2 years 8 months. A common error assumes payback occurs at exactly year 3 without interpolating within it. Always interpolate within the final year using the fraction: remaining balance ÷ that year's cash inflow × 12 months. 1 year 6 months does not follow from the cumulative cash flows; only £30,000 has been recovered after year 1.

Section B, Payback period — interpolation · Ref B1e · p2122

Question 35: B £70, since Division S must recover its variable cost plus the contribution it foregoes on lost external sales

With no spare capacity, every internally transferred unit displaces an external sale. Division S must therefore recover not only its variable cost (£40) but also the contribution it forgoes on the lost external sale: lost contribution = £70 − £40 = £30. Minimum transfer price = variable cost + lost contribution = £40 + £30 = £70. This equals the external market price, which makes sense — if Division S can sell externally for £70, it will not sell internally for less. The £40 answer applies only when there IS spare capacity and no opportunity cost. Midpoint and zero pricing ignore the economic reality of the opportunity cost.

Section C, Transfer pricing — no spare capacity · Ref C1d · p2046

Question 36: D Competitive benchmarking, using publicly available data to compare performance against direct competitors

Competitive benchmarking involves comparing performance against direct competitors, typically using publicly available financial or operating data rather than shared internal information — exactly the scenario described. Internal benchmarking compares performance across different parts of the same organisation. Functional benchmarking looks outside the competitor set to compare a specific process against organisations known for best practice in that function, regardless of sector. Collaborative benchmarking involves a formal arrangement where organisations agree to share internal data — the opposite of using only publicly available information.

Section C, Benchmarking types · Ref C1c · p2048

Question 37: D Customer satisfaction score derived from regular survey data

A customer satisfaction score measured through surveys is a non-financial performance indicator that directly reflects how customers perceive the organisation's products or services, making it well suited to the customer perspective of a balanced scorecard. Net profit margin, return on capital employed and earnings per share are all financial measures that would typically belong in the financial perspective rather than the customer perspective, even though they may be influenced indirectly by customer satisfaction levels.

Section C, Balanced scorecard — non-financial performance indicators · Ref C1c · p2060

Question 38: B Managers' personal objectives align with organisational objectives, so their decisions benefit both simultaneously

Goal congruence occurs when the performance measures faced by divisional managers lead them to make decisions that maximise their own metrics while also advancing the organisation's overall goals. Poor performance measure design (such as ROI inducing rejection of value-creating projects) creates goal incongruence. It is not automatic from budget-setting and applies regardless of whether divisions are similar in size.

Section C, Goal congruence definition · Ref C1b · p2098

Question 39: B £30,000

Residual income = operating profit − (net assets × cost of capital) = £180,000 − (£1,500,000 × 10%) = £180,000 − £150,000 = £30,000. The positive RI of £30,000 indicates the division is earning above its required return, adding value. The £180,000 figure is the operating profit before the capital charge. The £150,000 is the capital charge itself, not the RI. The negative figure (−£30,000) would occur only if the capital charge exceeded operating profit.

Section C, Residual income calculation · Ref C1c · p2102

Question 40: C RI credits any return above the cost of capital as positive, so managers accept value-creating projects that ROI would cause them to reject

RI credits the division with a positive result for any investment earning above the cost of capital, so a manager assessed on RI will accept a new project earning 16% when the cost of capital is 10%, since it adds to RI. A manager assessed on ROI may reject the same project if the 16% return dilutes their existing average ROI of (say) 20%. RI therefore aligns the manager's incentive with the company's interest in value creation. ROI and RI can and do give different decisions in exactly this way, and RI does not encourage uncontrolled asset-base growth — it penalises acquiring assets that earn below the cost of capital.

Section C, RI and goal congruence advantage over ROI · Ref C1c · p2103

Question 41: A £15,000 adverse

Contribution variance = actual contribution − budgeted contribution = £185,000 − £200,000 = −£15,000. Since actual is below budget, this is an adverse variance of £15,000. A favourable variance would mean actual exceeded budget. Quoting the full budgeted or actual figure as the variance conflates the two values. The sign convention is important: adverse means actual is worse (lower, for income; higher, for cost) than budget.

Section C, Controllable contribution variance · Ref C1b · p2105

Question 42: D When an active external market exists for the transferred product, making the market price a fair and objective benchmark that reflects the economic value of the transfer

Market-based transfer pricing is most appropriate when an active external market exists for the transferred product — this provides an objective, arm's-length benchmark that reflects the product's genuine economic value and avoids either division being subsidised by the other. Without an external market, a market price is unavailable (not merely theoretical), making cost-based or negotiated prices more common. The objective is to create a fair basis for both parties, not necessarily to minimise one division's costs. Tax-motivated transfer pricing is a separate, compliance-driven practice governed by arm's-length standards, not purely an internal policy choice.

Section C, Transfer pricing — market price basis · Ref C1d · p2108

Question 43: D Towards Country Y — low transfer price reduces high-tax X profit, increases low-tax Y profit

Shifting profit from 30%-tax Country X to 10%-tax Country Y saves the group 20% tax per pound transferred. A low transfer price reduces X's taxable profit and increases Y's, achieving this (option D). Option A misstates which country has the lower rate. Option B is wrong because, although the transfer price cancels out in pre-tax group profit, it changes where that profit is taxed and so changes the total tax paid. Option C is wrong for the same reason: the difference in tax rates is what drives the choice. Arm's-length transfer pricing rules under OECD guidelines (and most domestic tax codes) exist precisely to prevent this kind of profit-shifting for tax purposes.

Section C, Transfer pricing — tax implications · Ref C1d · p2124

Question 44: C Cost variances against budget, focusing on controllable cost efficiency

A cost centre manager controls only costs, so performance assessment should use cost variances comparing actual costs to budget (option C). ROCE, revenue growth and net profit margin (options A, B and D) all depend on revenues or capital that the manager cannot influence, so using them would be unfair and would undermine motivation.

Section C, Cost centre — appropriate performance measure · Ref C1a · p2127

Question 45: D Learning and growth — reflects investment in employee capability

Training days per employee measures investment in employee development and organisational learning capacity — the defining focus of the learning and growth perspective. It is not a customer metric, a direct financial return, or an operational process efficiency measure, even though it ultimately contributes to all three. Contrast this with the financial perspective (revenue, ROCE) or customer perspective (satisfaction scores) — both are outcome measures rather than the enabling investments that sit in learning and growth.

Section C, BSC — learning and growth · Ref C1c · p2128

Question 46: A £45 — where B's contribution falls to zero

Division B's contribution = £90 − TP − £45. Setting this to zero: TP = £90 − £45 = £45. At any price above £45, Division B earns a negative contribution from the transaction and would refuse. Division S's minimum is £30 (variable cost), so the negotiated range is £30–£45. Group contribution = £90 − £30 − £45 = £15 per unit, unchanged by the specific price within that range. £90 is the final selling price, which ignores Division B's own £45 of further costs.

Section C, Transfer pricing — maximum price for buying division · Ref C1d · p2129

Question 47: B 15%

ROI = operating profit ÷ net assets = £240,000 ÷ £1,600,000 = 0.15 = 15%. A common error divides net assets by profit (£1,600,000 ÷ £240,000 = 6.7), which reverses the calculation. The 24% and 12% figures do not follow from the figures given.

Section C, ROI calculation · Ref C1c · p2130

Question 48: C £48,000

RI = operating profit − (net assets × cost of capital) = £240,000 − (£1,600,000 × 12%) = £240,000 − £192,000 = £48,000. The positive RI confirms the division earns above its required return. The £192,000 is the capital charge, not the RI. The £240,000 is the operating profit before the charge. The division's ROI (15%) exceeds the cost of capital (12%), consistent with a positive RI.

Section C, Residual income vs ROI — same division · Ref C1c · p2131

Question 49: D Because including uncontrollable costs makes the assessment unfair and can demotivate the manager by holding them responsible for decisions made elsewhere

Including costs that the manager cannot influence makes their performance assessment depend on decisions made by others, which is unfair and typically demotivating. The controllability principle holds that performance measures should reflect what the manager can actually control. Head-office costs are real costs — they are simply not controllable at divisional level. The issue is one of fair attribution, not whether to share overhead information at all.

Section C, Controllability and performance fairness · Ref C1b · p2132

Question 50: D The BSC is built on cause-and-effect linkages between the four perspectives, so non-financial improvements ultimately drive financial outcomes

The balanced scorecard is explicitly designed around cause-and-effect linkages — improvements in the learning and growth perspective (training) drive better internal processes (quality), which improve the customer perspective (satisfaction), which ultimately deliver financial results (revenue). This is precisely the logic that makes the BSC a strategic tool rather than just a reporting dashboard. The four perspectives are interconnected, not independent. The linkages run from non-financial leading indicators to financial lagging outcomes, not the reverse.

Section C, BSC — cause and effect linkages · Ref C1c · p2136

Question 51: D It adjusts accounting profit and capital for a range of distortions (such as capitalising rather than expensing certain costs) to better approximate economic profit, then deducts a capital charge based on the adjusted capital employed

EVA starts from accounting profit but makes a series of adjustments intended to strip out distortions caused by accounting conventions — for example, capitalising expenditure like R&D or major marketing campaigns (which generate future economic benefit) rather than expensing it immediately, and adjusting the capital employed base accordingly. A capital charge (adjusted capital employed x cost of capital) is then deducted from this adjusted profit figure to arrive at EVA. It is not simply a percentage return like ROI, does not ignore the cost of capital, and is a genuinely different calculation from unadjusted residual income, not just a rebranding of it.

Section C, Economic Value Added (EVA) — concept · Ref C1c · p2150

Question 52: A Starting from the rightmost outcomes and working backwards, calculating expected values at chance nodes and taking the best option at decision nodes

The rollback method works from right to left — starting with the known outcomes at the ends of the branches, then working backwards through the tree. At chance nodes (circles), the expected value is calculated by probability-weighting the outcomes. At decision nodes (squares), the best option is selected (the highest EV branch), and other options are pruned. Working forwards from the initial decision would not be the rollback method; that is a forward pass used in different contexts. Selecting purely on highest single outcome ignores probability, and minimising the worst outcome is a maximin strategy, not the expected value rollback method.

Section D, Decision trees — rollback method · Ref D1a · p2053

Question 53: B Transfer, Avoid, Reduce, and Accept

The TARA framework identifies four possible risk responses: Transfer (pass the risk to a third party, e.g. through insurance), Avoid (eliminate the risk-creating activity), Reduce (take actions to lower the probability or impact of the risk), and Accept (consciously decide to live with the risk, often because the cost of other responses exceeds the benefit). The other options include plausible-sounding words but do not correctly name all four TARA responses — Analyse, Assess, Retain and Tolerate are not the correct TARA labels.

Section D, TARA risk framework · Ref D1b · p2054

Question 54: C Transfer — the financial consequences of the risk are passed to an insurer

Taking out insurance passes the financial consequences of the risk to a third party (the insurer) in exchange for a premium — this is the defining feature of the Transfer response in TARA. Avoidance would require ceasing the storage activity altogether to eliminate the risk. Reduction would involve taking preventive measures to lower the probability or potential impact of flooding, such as building flood defences. Acceptance would mean consciously choosing to do nothing and bearing the cost of any flood loss directly, which is the opposite of paying for insurance.

Section D, TARA — choosing appropriate response · Ref D1b · p2055

Question 55: A Because the accounting profession's role in providing credible financial information underpins public trust in capital markets and the wider economy

Professional accountants produce or assure financial information that market participants, investors, lenders and governments rely on to make decisions. If accountants were to act solely in client interests at the expense of accuracy, completeness or integrity, public trust in financial information would erode, undermining the functioning of capital markets and the broader economy. This is why the CIMA Code of Ethics requires accountants to act in the public interest as a fundamental principle. Acting ethically does not always maximise short-term employer profit, the public interest obligation extends beyond audit engagements, and it has very practical consequences — including professional sanctions — for real decisions.

Section D, Ethics and the public interest · Ref D1d · p2057

Question 56: B Sensitivity shows how much a variable can change before the decision reverses, without probabilities; EV weights outcomes by probability

Sensitivity analysis examines how much a single key variable (such as sales volume, selling price or operating cost) can change before the NPV falls to zero, without assigning probabilities to different scenarios — it highlights which variables the decision is most sensitive to. Expected value analysis instead assigns probabilities to possible outcomes and calculates the probability-weighted average, giving a single expected outcome. The two techniques approach uncertainty differently and are not equivalent. Option A is wrong for that reason. Option C reverses the two techniques: it is sensitivity analysis that changes one variable at a time, and EV that needs probability estimates. Option D is wrong because sensitivity analysis does not eliminate uncertainty; it maps its consequences.

Section D, Sensitivity analysis vs EV · Ref D1a · p2058

Question 57: B It ignores outcome variance, so risk attitude and extreme losses are not reflected

The fundamental limitation of EMV is that it averages outcomes weighted by probability but ignores the spread of those outcomes — a project with the same EMV as another but with a range of outcomes including catastrophic losses would be treated identically, even though a risk-averse manager would rationally prefer the less variable option. Risk attitude, scenario analysis and utility theory are used alongside EMV to address this limitation. EMV calculations are straightforward, not inherently complicated. The probability inputs do affect the result significantly, and EMV can handle any number of outcomes, not just two.

Section D, Limitations of expected value · Ref D1a · p2110

Question 58: C Refuse and raise the matter through appropriate internal channels such as a more senior manager or audit committee

The CIMA Code of Ethics requires professional accountants to maintain integrity and refuse to be party to the preparation of misleading information. The appropriate first response is to decline the request and escalate through appropriate internal channels — such as a more senior manager, internal audit or the audit committee — before considering more drastic action. Complying would be a clear breach of the fundamental principle of integrity. Adding an undisclosed footnote would not make the misleading presentation acceptable. Resigning immediately, before attempting internal resolution, would typically be an extreme last resort rather than the appropriate first step.

Section D, Ethics — pressure to misstate financial results · Ref D1d · p2115

Question 59: C 12.5%

Sensitivity = NPV ÷ PV of the variable = £8,000 ÷ £64,000 = 0.125 = 12.5%. This means contribution can fall by 12.5% before the NPV reaches zero — identifying how exposed the project is to a reduction in margin. 8.0% confuses the inverted ratio (£64,000 ÷ £8,000 = 8) with the sensitivity percentage. 64.0% reads the £64,000 as a percentage, and 6.25% does not follow from the figures.

Section D, Sensitivity analysis — contribution margin · Ref D1a · p2139

Question 60: B Managing upside risk — proactively positioning to exploit a positive uncertainty before it materialises

Proactively increasing capacity to benefit from an anticipated demand surge is an example of managing upside risk — recognising positive uncertainty and taking deliberate action to capture the opportunity before it fully materialises. This is the proactive, value-creating side of risk management. It is not downside risk management (there is no adverse consequence being mitigated here), not acceptance (which is passive), and not transfer (which passes consequences to third parties).

Section D, Upside risk — exploiting opportunities · Ref D1b · p2146