

### **General Comments**

Overall, performance was in line with expectations. Well prepared candidates were capable of obtaining very clear passes. Weaker candidates tended to avoid the requirements of the question, either through a failure to grasp what was required or as an attempt to obtain marks for repetition of memorised facts and information.

There was a tendency for the choice in the optional section to be biased towards numerical rather than discursive questions. While candidates should always select the questions with which they feel most comfortable, those preparing for future diets should take care to ensure that they are capable of writing about and explaining the issues covered in the syllabus.

Note that the attached marking scheme often makes more marks available than indicated on the question paper. This reflects the fact that questions at this level can often be approached in more than one way and that there is no single “perfect” answer. In applying this marking scheme, marks are always restricted to the total offered by the question and so there is no advantage to be gained from over-developing the answer to one question at the expense of another that may appear more difficult.

SECTION A – 50 MARKS  
ANSWER THIS QUESTION

**Question 1**

- (a) Discuss the main categories of risk that are faced by a bank such as IDAN and the advantages of risk categorisation in the design of a risk management system.  
(10 marks)
- (b) For every one of the six issues identified in the question, recommend the controls that might be introduced to minimise IDAN's exposure to such risks.  
(15 marks)
- (c) Compare and contrast the roles played by internal audit and risk management in organisations. Discuss the likely nature of the interaction between these two activities.  
(10 marks)
- The performance of the Managing Directors of the four types of business within IDAN is evaluated on the basis of the profits of their individual businesses. It has now been suggested by the Board that the strategy of the group, future investment opportunities and the profitability of each business should be evaluated against a risk-adjusted hurdle rate.
- (d) Critically discuss this suggestion by making reference to the information provided in the question.  
(15 marks)

**Rationale**

**Question One** is designed to test the candidates' ability to categorise risk, recommend appropriate controls in relation to such risks, recognise the function of internal audit and risk management and how hurdle rates may be used in the risk-return trade-off. The syllabus topics being tested are mainly B (Risk and Internal Control), C (ii, internal audit) and D (Financial Risk). The question meets the learning outcomes by providing a case study in the financial services industry which identifies trends and performance data. Candidates are expected to apply their understanding of risk management, internal control and internal audit to a financial services case.

**Suggested Approach**

**Part (a):** Candidates need to think about the likely risks facing a bank. While standard risk classifications are a useful start, particular issues facing banks will include credit risk in relation to money lent, trading on the derivatives market, reputational risk and compliance risk. The importance of classifications (e.g. market, operational, reputation, etc.) then needs to be explained in terms of how risk management is more easily handled with categories of risk rather than individual risks.

**Part (b):** For each of the six issues, 2-3 examples of controls should be recommended to address the risks.

**Part (c):** Candidates need to explain the roles undertaken by (i) internal audit and (ii) risk management, showing similarities and differences. They then need to explain interaction – how each influences and is influenced by the other.

**Part (d):** To critically discuss the performance of each type of business would require the calculation of RONA for each of the two years for each type of business. Candidates then need to interpret these figures in the light of the scenario information to relate profitability to risks and hurdle rates.

Marking Guide		Marks
<i>Part (a)</i>		
Discussion of main categories of risk		6
Advantages of risk categorisation for control		6
	<b>Max awarded for part (a)</b>	<b>10</b>
<i>Part (b)</i>		
For each of the six issues		3 marks each
	<b>Max awarded for part (b)</b>	<b>15</b>
<i>Part (c)</i>		
Compare and discuss roles played by internal audit and risk management		4
Discuss interaction		6
Note that the question asks about the role of the respective functions in any organisation, but for illustrative purposes only the solution uses IDAN to explain the pertinent issues		
<i>Part (d)</i>		
Computation of RONA for each business		
2 years = 8 calculations at ½ mark each		4
Commentary		11
Examiner's Comments		
Part (a) was generally answered well, with candidates identifying the risks that faced IDAN and suggesting suitable categories of risk.		
Part (b) was also answered well, with answers generally being linked to the scenario and with appropriate controls being suggested.		
The better answers to part (c) appeared to be based on an understanding of the roles of internal audit and risk management. Far too many answers were, however, based on the regurgitation of definitions and lists from study texts.		
Answers to part (d) were generally weak, with little apparent understanding of the concept of the risk-adjusted hurdle rate. Better answers highlighted the differences between the risks faced by the four business units.		
<i>Common Errors</i>		
The most common problem was the tendency to regurgitate material that may or may not have been directly relevant to the scenario. Questions are unlikely to reward lists of facts or points memorised from texts and candidates should concentrate on applying such material to the question as set.		
Weaker answers also frequently lacked depth. For example, answers to part (c) frequently made no attempt to discuss the interaction between internal audit and risk management, choosing instead to discuss each in turn.		
Many of the controls suggested in part (b) were either unrealistic or impractical. For example, it is unlikely that banks and their customers would find it cost-effective to require PIN numbers to be collected in person from branches rather than distributed by post.		
Very few answers to part (d) derived any figures from the information available from the scenario. For example, a comparison of Return on Net Assets yields some interesting issues.		

SECTION B – 50 MARKS  
ANSWER TWO QUESTIONS ONLY

**Question 2**

- (a) Advise regional managers as to the risks facing BJP as a result of the lack of apparent control over sales representatives and their expenses and recommend the controls that should be implemented by regional managers to rectify this situation. (12 marks)
- (b) Explain what an internal control system is, how it relates to the control environment and its likely costs, benefits and limitations. (8 marks)
- (c) Recommend how analytic review could be used in the internal audit of BJP's sales representatives' expenses. (5 marks)

**Rationale**

**Question Two** is designed to test the candidates' ability to make recommendations in relation to internal controls, understand the costs and benefits of internal control and show how analytic review can be used in internal audit. The syllabus topics being tested are mainly C (Review and Audit of Control Systems) and B (Internal Control Systems). The question meets the learning outcomes by providing a scenario of an organisation that appears to have little control over sales representative expenses. Candidates are expected to apply their understanding of risks, internal controls and internal audit to the scenario.

**Suggested Approach**

In answering this question, candidates need to be aware of the need to think beyond traditional accounting.

*Part (a):* Candidates need to identify risks in relation to the activities of sales representatives (i.e. how they spend their time); and the incurrance of costs. 3-4 examples of controls need to be provided in relation to each of sales representative activity, expenses, and general controls (personnel, training, discipline, etc.)

*Part (b):* This calls for an explanation of what a control system is, the control environment and each of the costs, benefits and limitations of control systems.

*Part (c):* Examples of analytic review should be provided in terms of how they could be used in internal audit.

Marking Guide	Marks
<p><i>Part (a)</i>  Risks arising out of the apparent lack of controls and recommendations for controls in respect of:</p> <ul style="list-style-type: none"> <li>Sales activities</li> <li>Expenses claims/recording</li> <li>General controls</li> </ul>	<p>5 (max)  5 (max)  5 (max)</p>
<b>Max awarded for part (a)</b>	<b>12</b>
<p><i>Part (b)</i>  Explanation of internal control system and its components  Control environment  Costs, benefits &amp; limitations of internal controls</p>	<p>3 (max)  3 (max)  4 (max)</p>
<b>Max awarded for part (b)</b>	<b>8</b>
<p><i>Part (c)</i>  Concept of analytic review and how it may be used in BJP</p>	5
<b>Examiner's Comments</b>	
<p>This question was generally answered well, apart from the common weakness in part (a) discussed below. It is satisfying that a large proportion of candidates applied themselves to the question's requirements.</p>	
<i>Common Errors</i>	
<p>Answers to part (a) were generally weak because many candidates concentrated on sales representatives' expenses and missed the wider issues associated with the freedom granted to the sales representatives.</p>	
<p>In part (b) few candidates appeared to know what a control environment was, often attempting to repeat a definition and being unable to add anything else to their answer.</p>	

### Question 3

Write a formal report to the Board of AMF that:

- discusses the advantages and disadvantages of outsourcing the ERPS system as suggested above;  
(5 marks)
- identifies the main risks involved in outsourcing the ERPS and suggests how these risks might be mitigated through internal controls and internal audit;  
(10 marks)
- recommends the processes and controls that AMF should adopt to manage a project for successful transition to a chosen outsource supplier should that be the decision of the Board.  
(5 marks)

*(Total for Question Three= 25 marks including 5 marks for style, coherence and presentation of the report)*

### Rationale

**Question Three** is designed to test the candidates' ability in relation to risk in information systems in general and outsourcing of IT in particular and show how internal controls and internal audit can mitigate the risk. The syllabus topics being tested are mainly E (Risk and Control in Information Systems). The question meets the learning outcomes by providing a scenario in which an ERPS system is to be outsourced. Candidates are expected to apply their understanding of IT systems, risk and control and to write a report identifying the advantages and disadvantages of outsourcing, evaluating the main risks and recommending appropriate controls.

### Suggested Approach

As this question allocates 5 marks for a formal report, it should contain an introduction, conclusion, main heading, and a structure with sub headings. There should also be a logical flow to the report.

The question calls for both advantages and disadvantages of outsourcing to be discussed. The main risks of outsourcing should be identified and for each of those main risks, suggestions should be made as to how it may be mitigated, and recommendations made regarding the implementation process and controls for transition to an outsource supplier.

### Marking Guide

### Marks

Structure, style, coherence and presentation	5
Discussion of advantages and disadvantages	5
Identification of main risks and mitigation	10
Processes and controls to achieve successful transition	5

### **Examiner's Comments**

This question rewarded candidates who had taken care to read its requirements carefully and apply themselves accordingly.

#### *Common Errors*

A large number of candidates failed to write a report, as requested. In many cases, answers started off in a report format but failed to continue in that style. Clearly, this cost some of the marks offered for presentation.

Answers often dealt with general issues associated with outsourcing, rather than focussing on the specifics of the successful operation of the system as described in the question.

The question clearly asked for a discussion of the transition to a *chosen* outsourcing company and yet many candidates wrote in some detail about how a company should be chosen.

#### Question 4

Write a report for the Directors of AL and Co. that:

- Details the inadequacies of the current 'internal control' system within the company and possible changes that could be made to improve the system; (10 marks)
- Explains why the rise in variable overhead costs is a matter of concern from both an external audit and an internal control perspective, and thus requires immediate agreement on a co-ordinated response to investigate the possibility of fraud; (5 marks)
- Briefly explains the limits of the responsibility of external auditors to detect fraud; (5 marks)
- Explains why the company should prepare a fraud response plan, and outlines the issues to be considered in drafting such a plan. (5 marks)

#### Rationale

**Question Four** seeks to test the candidates' ability to identify shortcomings in internal controls systems, and the parties responsible for fraud management and detection. By placing the question in the context of a small sized business, the need for fraud control across all types and sizes of business is emphasised. The syllabus topics being tested range across both B (Risk and Internal Control) and C (Review and Audit of Control Systems). Candidates are expected to recognise that control of directors is central to fraud management and to identify mechanisms for improving internal controls, as well as understand the limited role of the external auditors in relation to fraud detection. The design of a fraud response plan forms the final part of the question.

#### Suggested Approach

While this question asks candidates to write a report, no marks are allocated for structure, style, etc but candidates are encouraged to structure their answer in this format.

Candidates need to comment on the inadequacies in the existing internal control system both generally in terms of the responsibility of directors and specifically in relation to the scenario. Possible improvements to those controls should be suggested and candidates need to think beyond traditional accounting controls.

Candidates need to explain why variable overhead costs may be of concern particularly in relation to the suggestion of fraud, but explain the limited responsibility external auditors have to detect fraud.

The need for a fraud response plan and issues to be addressed in responding to fraud should be covered in the answer.



Marking Guide	Marks
<ul style="list-style-type: none"> <li>• General commentary on lack of controls and directors' responsibilities re internal control Specific inadequacies of AL &amp; Co. internal controls and recommended changes</li> <li>• Auditors' information requirements re assurance Current lack of audit trail raising suspicions of fraud</li> <li>• Specification of external auditors' responsibilities re fraud</li> <li>• The case for a fraud response plan Issues to be considered in establishing a plan</li> </ul>	<p>10</p> <p>5</p> <p>5</p> <p>5</p>
<b>Examiner's Comments</b>	
<p>This was the least popular of the optional questions. Those candidates who attempted it at all tended to write relatively brief and under-developed answers.</p>	
<i>Common Errors</i>	
<p>Answers frequently identified weaknesses, but failed to suggest satisfactory controls. An unrealistic burden was placed on the internal audit department.</p>	
<p>The discussion of the concerns raised by the variable overhead was frequently written only from an internal audit perspective rather than the external audit and internal control aspects as required by the question.</p>	
<p>Discussion of the limits of the ability of the external auditor to detect fraud and of the fraud response plan was generally superficial, with many candidates demonstrating very poor knowledge of fraud response plans.</p>	

### Question 5

- (a) Critically comment on the validity of the views and recommendations expressed by the Managing Director and explain how currency hedging might nevertheless be beneficial to SDT. (6 marks)
- (b) Calculate the sterling value of the contribution earned from exports to each of the customers (A, B and Europe) assuming that SDT
- (i) hedges the risk in the forward market; (3 marks)
- (ii) does not hedge the risk and the relevant spot exchange rates in two months' time are as follows:
- Two month spot*

Yen/£ 200·18-202·63

US\$/£ 1·7650-1·7750

Euro/£ 1·4600-1·4680
- (3 marks)
- (iii) aims to maximise its contribution to sales ratio, calculate the average contribution to sales ratio in each of the above scenarios and advise SDT accordingly on whether to hedge its foreign exchange exposure. (3 marks)
- (Total for requirement (b) = 9 marks)**
- (c) Comment on why (based on relative risk analysis) a company might seek to generate higher rates of return from export sales compared to domestic sales. (6 marks)
- (d) If the payment from Company B is received late, briefly explain what risk SDT is taking in hedging B's payment in the forward market, and how this risk could be avoided? (4 marks)

### Rationale

**Question Five** tests the candidates' understanding of the management of financial risk (syllabus section D) and specifically currency risk. A little over one third of the marks go for computational exercises, with the remaining marks allocated for critical commentary on various issues related to foreign exchange risk. Candidates are expected to understand the pros and cons of currency hedging and be able to interpret spot and forward rate data to estimate revenue flows. Understanding of the limitations of forward contracts is also tested. Additionally, candidates are asked to comment upon the relative risk: return requirements for domestic versus overseas sales.

<b>Suggested Approach</b>	
<p><i>Part (a):</i> Candidates should <u>critically</u> comment on the Managing Director's approach to the risk of foreign exchange losses and the benefits of hedging.</p> <p><i>Part (b):</i> For each of the 3 sections, candidates should carry out the appropriate calculation, showing all workings clearly.</p> <p><i>Part (c):</i> Candidates should consider the differences between sales in the home country and those to export markets to explain why higher returns may be looked for.</p> <p><i>Part (d):</i> The risk facing the company should be explained and how this risk could be mitigated.</p>	
<b>Marking Guide</b>	<b>Marks</b>
<p><i>Part (a)</i> Critical commentary on MD's views in respect of market efficiency and how currency hedging may be beneficial</p>	6
<p><i>Part (b)</i></p> <p>(i) Computation</p> <p>(ii) Computation</p> <p>(iii) Computation and advice</p>	3 3 3
<p><i>Part (c)</i> Comment on reasons why a higher return may be sought on export sales</p>	6
<p><i>Part (d)</i> Risk being taken Methods of mitigating the risk</p>	4
<b>Examiner's Comments</b>	
<p>This was by far the most popular optional question. The quality of answers was very variable, with weaker attempts failing to focus on the question's requirements in any great depth.</p> <p><i>Common Errors</i> Answers to (a) frequently ignored the MD's comments and simply made general points about world events or hedging techniques.</p> <p>A large number of candidates managed to score full marks for part (b). However, a substantial minority calculated sales values or contribution per unit rather than total contribution as required.</p> <p>Answers to part (c) were either extremely good or extremely poor, with poor answers demonstrating no real understanding of the matter.</p>	