

General Comments

Overall, performance was poorer than expected. Well-prepared candidates were capable of obtaining very clear passes. Weaker candidates tended to not answer 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 were fewer clear passes than expected in this paper.

Generally one of the main problems was a failure to relate the answers to the situation portrayed in the question. High marks were achieved by candidates who did this. When information is given in the scenario candidates will be expected to use it to illustrate the main issues in their answer. Candidates should ensure they use the reading time to read the questions carefully.

There was a tendency for the choice in the optional section to be biased towards more general risk management questions and for candidates to avoid the more specific questions. Very few candidates attempted Question Two but those who did tended to gain high marks, as they were well prepared for the topic. 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 answering questions on all areas of the syllabus. Avoiding Question Two left candidates with little choice for the other optional questions.

Please note that the marking guide included in this Post Exam Guide 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) Identify and briefly discuss two risks that are likely to be faced by the GHI Group under each of the following categories:
- Financial
 - Political
 - Environmental
 - Economic
- (16 marks)*
- (b) Identify and evaluate risk impact upon GHI's financial statements and cash flow management of choosing to purchase its own overseas hotel properties as opposed to block booking rooms from local suppliers under the terms of the 2003 -2005 contract.
- (15 marks)*
- (c) Identify and comment upon the changes in risks to GHI Group that might arise from the decision to sell premium all-inclusive deals, and suggest methods by which these risks might be monitored and controlled.
- (8 marks)*
- (d) Explain, using the investment in the new hotels as an example, how strategic decisions can simultaneously affect both performance measurement and capital allocation across a number of different companies within a group such as GHI.
- (6 marks)*
- (e) List the tasks that the internal audit department of GHI should have performed to ensure that the risks associated with the new hotel purchases are managed effectively. You should assume that its involvement commenced immediately the strategic decision was made to purchase overseas property - in other words, prior to identification of target sites.
- (5 marks)*

(Total for Question One = 50 marks)

Rationale

Question One tests a candidate's ability to identify and evaluate the risk implications of strategic decisions. The decisions to switch from using local hoteliers to owning and managing company owned hotels, whilst simultaneously introducing new premium products both carry lots of potential risks of a financial and non-financial nature. The question also requires candidates to understand the inter group impact of such key decisions, particularly in relation to both performance measurement and capital allocation. The question requires application of knowledge rather than regurgitation of facts as is typical of all Section A questions to date. The main syllabus topics being tested are B (i) and (ii) which cover the identification of risks and their measurement and assessment. Part (b) specifically tests syllabus section D(i) on evaluation of financial risks, and the Review and Audit of Control Systems (syllabus section C) is tested in part (e) of the question.

Suggested Approach

- (a) The question guided candidates on possible risk categories to be used in this part of the answer and a lot of information was included in the question about specific types of risk. The use of categories to structure an answer helps avoid the risk of repetition and hence wasted time. The requirement was for only two risks in each category but this point was missed by many candidates.
- (b) The route to marks here was to note the significant key terms of financial statements and cash flow management. The question does not require repetition of part a) because it focuses specifically on the risks arising from the hotel purchase. Muddling the answer to include the premium packages does not gain any extra marks. Answers need to be very specific about which financial statement is being impacted and how.
- (c) As with (b) this question focuses on a specific issue, namely the introduction of the premium packages. Generic answers covering a whole range of risks will gain no additional marks. Additionally, care needs to be taken to offer solutions to the identified risks as well as commentary on them.
- (d) Easy marks can be collected by referring to the capital rationing that might impact on other divisions as a result of the investment decision, The main points to note are the interdependency of group performance and individual company performance and hence the potential need to review the whole performance measurement system.
- (e) Candidates need to show a good understanding of the role of the internal audit function, as opposed to the risk management function. The two roles are interrelated but different, and good answers will focus on the verification of control mechanisms not on control design.

Marking Guide

	Marks
(a) Types of risks under various categories	2 per relevant risk
(b) Potential impact of hotel purchases on P & L, balance sheet and cash flow statements and management	1 mark for each risk plus bonus mark for linking to specified financial statement
(c) New risks from product change (premium packages)	4
Methods of control	4
(d) Explanation of interdependence	3
Localised impact /risk changes	3
(e) Internal audit tasks	5 (max 2 for general discussion)

Examiner's Comments

This question was reasonably well answered. One common failing was candidates not answering the exact question asked. Some general answers on risk were given particularly in parts (c) and (e). High marks were only awarded where the question was answered in full and related back to the scenario.

Common Errors

- (a) This part of the question was done well by most candidates. The suggested structure was used, however many candidates did not put the risks under the correct categories.
- (b) Many candidates did not answer the requirement to relate their answer to the effect the decision to purchase hotels would have on the financial statements. As a result they failed to get high marks. Most candidates correctly identified a number of the risks but failed to mention how these could impact on the financial statements. Many candidates wasted valuable time performing calculations when none were required.
- (c) Many candidates failed to focus on the risks of the premium package and merely listed generic risks of running a new hotel. Specific answers were required which related back to the scenario.
- (d) Few candidates went into enough detail on the performance measurements required. Many candidates missed out this part of the question. The part of the question relating to the implications of the large capital investment on capital rationing throughout the group were answered in more detail, with many candidates getting reasonable marks.
- (e) This was the section which was done least well in question 1. Many candidates did not restrict themselves to the risks, which would be most likely to occur before the project was undertaken. Many candidates wrote about risks that could occur after the hotels were opened. Many candidates also only wrote about controls they would design rather than verifying that risks were being properly managed.

SECTION B – 50 MARKS
ANSWER TWO QUESTIONS ONLY

Question 2

- (a) Explain and discuss the reasons for such divergent viewpoints. *(13 marks)*
- (b) Explain the additional risks arising from these rules that may be faced by companies which choose to exercise the fair value option and/or regularly trade derivatives for profit. *(5 marks)*
- (c)
- (i) Explain the meaning of the term “value at risk” from the perspective of a fund manager. *(4 marks)*
- (ii) Calculate and comment upon the value at risk of the portfolio, assuming a 95% confidence level and a one day holding period. *(3 marks)*
- (Total for Question Two = 25 marks)*

Rationale

Question Two covers a range of topics that fall within Section D of the syllabus - Managing Financial Risk. The focus is on derivatives because a number of recent corporate scandals have brought this issue to the attention of the media. Candidates need to understand that derivatives are a very useful tool for reducing financial risk, but failure to control their use can also be very dangerous. Part (b) tests a candidate’s understanding of the financial reporting risks that may result from trading derivatives rather than just using them as a hedging tool. Understanding of the costs and benefits of a specific control system (syllabus section B (vi)) – Value at Risk- is tested in the final part of this question, which also tests numerical understanding of this risk measure.

Suggested Approach

- (a) A good answer will clearly explain what is meant by the term derivative, and include simple definitions. This will be followed by a well balanced explanation and discussion of the alternative perspectives. Derivatives are widely used tools to manage and reduce risk, but their price volatility and gearing element means that they are inherently risky when used for trading. The discussion should reach a conclusion that both points of view are valid and that without both speculators and hedgers the liquidity of derivatives markets would be very low.
- (b) Some marks could be gained for simply using the information given in the question that changes in fair value are recognised in profit and loss. A good answer required understanding of the methods used to obtain fair value, and the potential volatility of such values which will impact profits even when unrealised.
- (c) (i) This was not a question to “guess at” as although widely used, Value at Risk is a highly specific concept. The term fund manager is important in framing an answer as many funds need continual growth in value but changes in fair value could impede this.
(ii) There are two requirements here- to calculate and comment upon, both of which earn marks. The calculation required knowledge of the number of standard deviations required for 95% confidence limit and needed use of the tables. The comment requires consideration of the size of the VaR relative to the value of the portfolio and a decision on whether it is large enough to worry about.

Marking Guide	Marks
(a) Alternative types of derivatives and their uses	3
Equal split of marks for discussion of each viewpoint	10
(b) Risks from IAS 39 rules	5
(c) (i) Explanation of VaR	4
(ii) Calculation and commentary	3

Examiner's Comments
This was the least popular of all the optional questions. Clearly many candidates had not learned this area of the syllabus.
<i>Common Errors</i>
This was the least popular of all the questions and was done by very few candidates.
(a) This part was done very well by most candidates. Some candidates however only discussed derivatives from a hedging perspective and did not mention speculation; these candidates did not attain high marks. It was essential that both perspectives were discussed to fully answer the question.
(b) This part was very poorly answered. Several marks could be gained by using information in the scenario. Many candidates did not seem to understand the role of derivatives except for hedging. Candidates did not appear to have much knowledge of the financial reporting requirements for derivatives. Many candidates missed out this part of the question.
(c) This was a straightforward calculation and was done very badly. Some revision of this whole topic would benefit candidates in the future.

Question 3

For an organisation like LMN:

- (a) Discuss the purposes and importance of risk management and its relationship with the internal control system.

(8 marks)

- (b) Explain the importance of a management review of controls for the audit committee.

(5 marks)

- (c) Discuss the principles of good corporate governance as they apply to the Board's role

- (i) in conducting a review of internal controls; and
- (ii) reporting on compliance.

(12 marks)

Illustrate your answer with examples from the scenario.

(Total for Question Three = 25 marks)

Rationale

Question Three is designed to test the candidate's ability to identify the purposes of risk management and how risk management relates to internal controls. The question also requires candidates to demonstrate their knowledge of a management review of controls undertaken for the audit committee. Finally, the question requires candidates to demonstrate the principles of corporate governance in relation to the Board's role in reviewing internal controls and reporting on compliance. The syllabus topics being tested are mainly B (iii) (Risk and Internal Control); Management review of controls C (i) and the role of governance in relation to controls C (vi). The learning outcomes are achieved through the scenario of a charity in which the major risks have already been identified. Candidates are required to apply their knowledge of risk management and internal controls to this scenario.

Suggested Approach

- (a) The question requires candidates to break down the requirements and address each in turn, by discussing – examining in detail the three elements in the question. First, the purposes of risk management. This is about risk identification and assessment in order to determine appropriate risk responses. Second, the importance of risk management – improving the ability to respond to risks and to achieve its objectives. Third, the relationship between risk management and internal controls, particularly that internal controls should be developed as an outcome of the risk management process.
- (b) Candidates need to show that they understand that management review of controls is a process carried out by management to self-evaluate the organisation's control system and how this is one of the pieces of evidence, supplemented by audit reports and other independent sources, to enable the Board to evaluate the effectiveness of the internal controls.
- (c) Candidates need to show an understanding of the principles of good corporate governance as it relates to the Board's review of internal controls, through an Audit Committee. This involves an assessment of risks and their significance, and how effective controls are in relation to those risks. The second part of the question is in relation to the annual requirement for the Board to report to shareholders that they have reviewed controls and the issues that they have taken into account in that review.

Marking Guide	Marks
(a) Purpose and importance of risk management, and relationship between risk management and internal control	8
(b) Management review of controls for Audit Committee	5
(c) (i) Review of internal control	8
(ii) Report on compliance	4
Examiner's Comments	
<p>This was the most popular of the optional questions and was not done particularly well. Some candidates appeared to have difficulty applying Corporate Governance principles to an organisation which was not a listed company. The main problem was that candidates did not relate their answer back to the scenario.</p>	
<i>Common Errors</i>	
<p>This question is a good example of candidates not answering what was asked. Candidates should make full use of reading time to ensure they understand what is being asked. When there is a scenario, candidates should usually try and relate their answer to the information given.</p>	
<p>(a) This part was done well by most candidates.</p> <p>(b) The most common error was for candidates to discuss the role and structure of the audit committee rather than answer the question. The question required candidates to comment on the importance of self-evaluation of management internal controls by management. The audit committee has a role to play in this but general comments on the structure and other roles of the audit committee were not rewarded.</p> <p>(c) The most common error was for candidates not to take account of information in the scenario. The charity was a stakeholder organisation and was not a listed company. Many candidates simply wrote everything they knew about Corporate Governance and internal control. This strategy was not rewarded. The answer should have been related back to the circumstances of the charity.</p>	

Question 4

- (a) Recommend management controls that would be appropriate for the Principal to have in place for HIJ. (12 marks)
- (b) Discuss the need for various types of audit that are appropriate for HIJ. (8 marks)
- (c) Discuss the costs and benefits for HIJ that are likely to arise from a system of internal controls (5 marks)
- (Total for Question Four = 25 marks)*

Rationale

Question Four tests a candidate's ability to apply management controls to a small professional services firm controlled by a single Principal. Candidates need to understand the different types of audit that may be appropriate for this firm and be able to compare the costs and benefits of a system of internal control. The syllabus topics being tested are A (i) (Recommend appropriate management control systems); a plan for the audit of organisational activities C (iii) and the costs and benefits of internal controls B (vi).

Suggested Approach

- (a) As in scenario questions relating to controls in previous examinations, candidates are expected to recommend controls that are financial, non-financial but quantitative and qualitative. Specific examples of controls under each of these three headings should be given by candidates.
- (b) Candidates should demonstrate a broader understanding of audit, particularly as it applies to a small business. Examples could include cost audits, internal audits, management audits, etc. The **need** for each type of audit should be discussed in terms of the risks facing the business described in the scenario.
- (c) Candidates should identify both costs and benefits of an internal control system, which when applied to the scenario will include opportunity costs (for example, management time, loss of income, etc.) whilst candidates should recognise that many internal controls are simply good business practice.

Marking Guide

	Marks
(a) 4 marks for each of financial, quantitative and qualitative controls	12
(b) Need for various types of audit	8
(c) Costs and benefits of internal controls	5

Examiner's Comments

Again candidates had difficulty in applying their knowledge to the scenario. This was a very small organisation run by a qualified accountant with several other qualified accountants on the staff. Many candidates suggested they required an internal audit department. Others went to the other extreme and suggested all stationery invoices of over £2 should be checked by the Principal and signed by the company accountant. Clearly neither is appropriate. Reading the scenario and planning a sensible answer bearing in mind the organisation in the question, would be a huge benefit to candidates.

- (a) Some candidates did not discuss management controls but went into great detail on the need for receipts to be checked and for mileage checks. Otherwise, this part of the question was well done by the majority of candidates.
- (b) Many candidates did not relate their answer to the scenario. They just listed many types of audit and wrote about them. A good answer would have related the need for various types of audit back to the scenario and discussed those in terms of the risks facing that particular type of business. Clearly an internal audit department is neither feasible nor necessary. Financial audit is not a requirement unless the organisation is a limited company and of a reasonable size. Careful reading of the scenario and an answer plan would help candidates with these questions.
- (c) This part of the question was answered well by most candidates.

Question 5

- (a)
- (i) Outline the different types of information system available to manufacturing firms like CDE; and
 - (ii) Recommend with reasons the information system that would be appropriate to CDE's needs.

(10 marks)

- (b) Given the business environment that CDE faces, and the desire of management to reduce the cost of accounting,

- (i) critically evaluate the relevance of the current management accounting system; and
- (ii) recommend how the system should be improved.

(15 marks)

(Total for Question Five = 25 marks)

Rationale

Question Five provides the scenario of a manufacturer and candidates are required to outline different kinds of information systems that are available and recommend the most suitable to meet the needs of the company identified in the scenario. In the second part of the question, candidates are required to critically evaluate the relevance of the management accounting system described in the scenario and recommend improvements to that system. The syllabus topics being tested are evaluation of strategies to support management controls E (i) and the evaluation of IT systems appropriate to an organisation's needs E (ii).

Suggested Approach

- (a) Candidates should first briefly list the different types of information system, such as transaction processing, MIS, ERPS, SEM and EIS then recommend, with reasons, the most suitable given the scenario.
- (b) Candidates should demonstrate an understanding of the business environment in the scenario by evaluating – showing the value of – the current system, that is, its strengths and weaknesses. In doing so, the second part of this question gives candidates the opportunity to recommend, with reasons, how the system should be improved. In both cases, recommendations should address management's desire to reduce the cost of accounting. Answers could address budgeting, overhead allocation, costing, variance analysis, backflushing, etc.

Marking Guide

	Marks
(a) Different information systems	6
Recommendation of most appropriate	4
(b) Evaluation of current system and recommendations (1 mark per point)	Max 15

Examiner's Comments

This question was also poorly answered. Part (a) was reasonable with many candidates listing sensible information systems; however the second part of this was poor. Many candidates did not give reasons for their choice of the most appropriate system and did not achieve a high mark. Part (b) was also poor as candidates failed to address the cost of accounting. Again, careful reading of the scenario pays dividends.

Common Errors

- (a) While most candidates listed several types of information system many failed to give sensible reasons for choosing one particular system. This section was not very well done. Many candidates failed to critically evaluate the present system and did not mention ways of reducing the high cost of accounting.
- (b) Some knowledge of strategic management accounting was expected. Usually when the question requires recommendations to be made it suggests there are some problems with the existing system. Many candidates were in favour of the existing system and saw no need to change.