General Comments

Overall, performance was in line with expectations. Well prepared candidates were capable of obtaining very clear passes, it was pleasing to see some candidates achieve exceptionally good marks. 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.

Generally one of the main problems was a failure to relate the answers to the situation portrayed in the question. Good marks were achieved by candidates who did this.

There were no questions noticeably avoided by candidates. Candidates should always select the questions with which they feel most comfortable, however those preparing for future diets should take care to ensure that they are capable of answering questions on all areas of 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) Analyse the risks facing BLU in relation to

(i) its investment appraisal and approval process; and
(ii) the information system feeding that process.

(20 marks)

(b) Explain how, as an internal auditor, you would plan an audit of BLU's existing capital investment process (and the information system feeding that process), highlighting those elements of the process that you would pay particular attention to under a risk-based approach.

(10 marks)

(c) Recommend to the Board of BLU the internal controls that should be introduced to improve BLU's capital investment process (including the information system feeding that process) and explain the benefits of your recommended controls.

(20 marks)

(Total for Question One = 50 marks)

Rationale

Question One is a manufacturing scenario and is designed to test the candidate's ability to "look behind the numbers" in a capital investment proposal and to recognise that, despite the apparent accuracy implied by a net present value calculation, the assumptions leading to the estimates of future cash flows may be very questionable. The question requires no calculations, but is one where candidates are expected to interpret the numbers and to think about the risks in the capital investment process and the information system that produces the forecast cash flows. The question goes on to ask candidates to plan an internal audit of the capital investment process, based on the risks identified in response to the first part of the question. Finally, candidates are expected to recommend internal controls to improve the capital investment process, and to explain the benefits of those controls. The learning outcomes tested are mainly B (i) and B (v) in relation to risks and internal control, C (iii) for an internal audit plan, A (iv) in relation to control systems generally, and E (iv) which is specific to information systems. This is a good example of a scenario that cuts across four of the five syllabus areas.

Suggested Approach

Requirement (a) requires candidates to identify the risks. Each element of the scenario needs to be considered in terms of the risks. Risks relating to both the investment appraisal process and the information system should be identified and as in previous examinations these risks should not be limited to accounting or financial ones. The risks are largely concerned with the subjectivity of the forecasts, the use of historic information and the unquestioning acceptance of information and assumptions.

Requirement (b) requires candidates, based on the assessment of risks, to plan an internal audit on the basis of those risks. This would involve scoping the audit with the specific approach taken consistent with the risks identified in (a). Requirement (c) then requires candidates to recommend internal controls that are consistent with the risks identified, so again these would primarily focus on improving forecasts, introducing more objective methods and questioning the assumptions used in both the capital investment process and the information system feeding that process. Part (c) also requires candidates to explain the benefits of the recommended controls. The benefits must relate to how the controls are likely to reduce the risks.
NOTE: Answers are not sufficient to pass if they are lists of generic risks, audit approaches and internal controls. The answers MUST be related to the scenario.

Marking Guide	Marks
1 (a) Identifying risks of information system	10
Identifying risks for capital investment approval process	10
1 (b) Scoping the audit with marks for each element identified in the audit plan	10
1 (c) Identifying internal controls	10
Identifying benefits of each control	10

Examiner's Comments

Candidates must use the reading time to make sure they understand what is being asked.
The questions are quite specific and general answers will get poor marks. The answers should always relate to the scenario.

Part (a) was generally done well by most candidates.

Part (b) was done poorly by many candidates. Some candidates appeared to misinterpret the question and went into great detail about examining invoices and checking arithmetic. This was not what was required. The approach to the internal audit was what was required. Many candidates did not mention scoping the audit and others did not relate the answer to the scenario.

Part (c) was not answered well either, with a number of candidates identifying the internal controls but not mentioning the benefits of the controls.

Common Errors
Part (b) – Not relating the planning of the audit to the scenario was the most common error. Generic answers relating to audit planning did not get high marks. Some candidates answered as if it was external audit and again did not achieve high marks.

Part (c) – Again this answer had to refer to the scenario. A generic answer got poor marks.
While the internal controls would normally relate to the risks identified in part (a), an answer which repeated the answer to part a, did not get high marks.

SECTION B – 50 MARKS
ANSWER *TWO* QUESTIONS ONLY

Question 2

(a) Assuming that you are STU's Head of Internal Audit, recommend the actions that should be taken in connection with the design, development and delivery of the SEM system.

(13 marks)

(b) Advise the audit committee of STU about

(i) possible approaches to auditing computer systems; and
(ii) the controls that should exist in an IT environment.

(12 marks)

(Total for Question Two = 25 Marks)

Rationale

Question Two is a scenario of a distribution business implementing a strategic enterprise management (SEM) system. This is designed to test candidates' ability to understand the role of internal audit and internal controls in the design, development and delivery of a new IT system and candidates are expected to make recommendations in relation to a project management structure to ensure that the design, development and delivery of the SEM is effective. The question also requires candidates to advise the audit committee about approaches to the audit of computer systems and the controls that are particularly relevant to an IT environment. The learning outcomes tested are mainly E (iv) and (v) in relation to improving the control and audit of information systems and C (iii) a plan for the audit.

Suggested Approach

Requirement (a) expects candidates to recommend actions in relation to a computer system involving the design, development and delivery. It would be almost impossible to satisfactorily answer this question without a project management-type approach that covers each of these stages, including design acceptance through steering committees, management support for the project, resourcing, quality control, risk management, approval and testing, etc. Whilst many elements of project planning will be generic, answers must be related to the scenario.

Requirement (b) asks candidates to advise about possible approaches to auditing computer systems and controls in an IT environment. Answers need to be related specifically to IT systems hence computer security, data entry, control self assessment, embedded audit etc. would all be appropriate. In terms of controls, IT system controls should encompass personnel, physical, input/process/output, network and business continuity, etc. As with all such questions, it is important to give reasons to support your advice.

Marking Guide	**Marks**
2 (a) Marks allocated for each action identified	13
2 (b) Approaches to auditing computer systems – with reasons	6
Controls in an IT environment – with reasons	6

Examiner's Comments

This question was answered well by most candidates.

Common Errors

Part (a) - Some candidates did not relate their answer to the scenario.

Part (b) - Some candidates did not relate their answer to an IT environment. To gain high marks answers should have specifically concentrated on auditing and IT. Some candidates only discussed general approaches to audit and got poor marks.

The reasons for these controls should have been discussed in depth, again many candidates failed to discuss controls in any detail.

Question 3

Using the information contained in the above scenario to develop your arguments, answer each of the following questions:

(a) Discuss how decisions about company structure, market types and location can impact upon the risk profile of a company.

(12 marks)

(b) Compare and contrast the risks associated with the differing approaches to the Treasury function adopted by the two companies in the above scenario.

(4 marks)

(c) For **either** Company A **or** Company B as described in the scenario, taking into account its current structure and size, recommend **one** example of **each** of financial, non-financial quantitative, and non-financial qualitative controls that may be useful tools in monitoring exposure to either strategic or operational risks. You should briefly justify your choices.

(9 marks)

(Total for Question Three = 25 marks)

Rationale

Question Three is a question about two US listed companies that have different structures, strategies and markets. The question is intended to test candidates' understanding of how decisions about corporate strategy work to influence decisions on structure and marketing. All of these issues will in turn influence the design of performance management systems and risk exposure. Other elements of the question require consideration of the relative risks of centralisation versus de-centralisation of the treasury function, and recommendations of a range of financial and non financial controls suitable for managing the risks identified in the company scenarios. The learning outcomes being tested in this question are B (i) and (ii) in relation to risk identification and assessment, A (ii) which tests evaluation of controls, and C (v) on recommendations of actions to improve controls.

Suggested Approach

Part (a) requires discussion of the impact of different types of structures, strategies, markets and location upon a company's risk profile. The question does not ask for discussion of the specific risk profile of each company in the scenario, but for generic comment on each issue. For example the issue of market types could be discussed by reference back to the fact that Company A operates in markets that are diversified both by customer type and location, but risk is increased by dependence upon two key customers. The issues of market type, relative significance of particular customers and access to markets are all relevant here.

Part (b) requires straightforward discussion of the pros and cons of centralising the treasury function. This does not simply mean writing down two directly opposite perspectives eg more efficient versus less efficient. To gain full marks four separate issues have to be discussed.

Part (c) requires the candidate to select just ONE of the scenario companies and suggest ONE control in each category, with brief justification. Attention should be given to the need for both qualitative and quantitative non-financial controls, and answers need to include specific suggestions. Comments such as "profit monitoring" are insufficiently precise to gain a pass mark on this section.

Marking Guide	Marks
Link between structure and strategy	2
Company structure impact on risk	4
Market types and location linked to risk profile (max of 3 marks if not linked to risk)	6
Centralised (pros and cons)	2
De- centralised (pros and cons)	2
Each type of control – 1 mark for identification and 2 for discussion	Max 3 each

Examiner's Comments

This question was answered reasonably well by most candidates.

Common Errors

Part (a) The link to strategy should have been clearly made in the answer. Some candidates ignored this completely.

Part (b) Some candidates only mentioned opposites for pros and cons. This meant that only half the marks were available to them.

Part (c) This part of the question was well answered.

Question 4

(a) Assuming that the spot rate and the futures rate turn out to be the same in February 2007, indicating that there is no basis risk, identify the lowest cost way of hedging the exchange rate risk (using either futures or options) where the exchange rate at the time of payment is:

(i) $1·665/£
(ii) $1·720/£

Note: Your answer should show all the calculations used to reach your answer, including the extent (if any) of the uncovered risk.

(10 marks)

(b) Briefly discuss the problems of using futures contracts to hedge exchange rate risks.

(6 marks)

(c) Identify and explain the key reasons why small versus large companies may differ in terms of both the extent of foreign exchange and interest rate hedging that is undertaken, and the tools used by management for such purposes.

(9 marks)

(Total for Question Four = 25 marks)

Rationale

Question Four tests understanding of the techniques available for managing foreign exchange risk via the use of either futures contracts or options. The questions tests both numerical and discursive knowledge of the topic, and also the factors that may influence a company's decision to hedge foreign exchange risk, including company size. The syllabus topics being tested all fall within Part D of the syllabus, which covers management of financial risk. The learning outcomes being tested are (vi), requiring recommendation of currency risk management strategies, (iii) which requires evaluation of alternative risk management approaches and (ii) on identification and evaluation of alternative approaches to financial risk management. It is recognised that there is strong overlap between (ii) and (iii).

Suggested Approach

Part (a) requires the completion of calculations relating to BOTH options and futures transactions, including the computation of the size of the option premium. The futures element should be approached by assessing the required number of contracts, the amount left unhedged and then calculation of the outcome at the given exchange rate. The options calculation must include a conclusion on the efficacy of exercising or not exercising the option.

Part (b) requires explanation of the problems of using futures contracts, and includes issues such as minimum contract size, inflexibility of both timing and value, and the cash flow implications of margin payments.

Part (c) asks for discussion of the reasons why small and large firms differ in their approaches to both foreign exchange and interest rate hedging. The question is open to slightly different interpretations insofar as it could be read as asking why the tools used differ according to company size. Alternatively it could be read as asking simply for some detail on hedging tools. In the marking process both approaches were given full credit.

Marking Guide	**Marks**
Options calculations	4
Futures – contract number	1
- unhedged amount	1
- Outcomes (2 per case)	4
Problems of hedging using currency futures	
- 2 marks per point as Solution, but must discuss)	6
Tools used for hedging	Max 3
Differences between small and large companies	6

Examiner's Comments

Few candidates used the correct rates in all sections of the question in part (a). This was disappointing. Very few candidates attempted to calculate the premium on the option.

Common Errors

Part (a) Very few candidates achieved the high marks expected in this question. Some revision of this area of the syllabus is recommended.

The premium on the option was tricky to calculate but few candidates made any attempt to do so. Many candidates adopted the approach of just using all the rates in the hope one would be correct, this approach got few marks.

Part (b) This part was done well by most candidates.

Part (c) Candidates were unclear as to the most appropriate methods of hedging for small and large companies.

Question 5

Write a report advising the Board of Directors of a stock market listed company on:

- the key responsibilities of Board members in relation to ensuring the effectiveness of internal controls;
- the methods used to assess such effectiveness; and
- the regulations that govern the reporting to the stock market of the results of internal control reviews.

An indicative mark allocation for the three points above are 5, 10 and 5 marks respectively.

(Total for Question Five = 25 marks)
(includes 5 marks for report format and style)

Rationale

Question Five provides candidates with a chance to display their knowledge of governance regulations in relation to board of director responsibilities regarding internal controls. The question covers responsibilities in the areas of ensuring control effectiveness, methods used to assess effectiveness and the reporting of internal control reviews to the stock market. The suggested solution is drafted from the perspective of a UK listed company, but other international contexts are acceptable. The question tests basic knowledge rather than the application of knowledge to a particular scenario. The learning outcomes being tested in this question are from Section C of the syllabus, namely C (i), which requires understanding of the importance of management review of controls, and C (vi) and C (vii) which cover the principles of good corporate governance for listed companies and the importance of ethical principles in reporting on internal reviews.

Suggested Approach

The key to a good mark in answering this question is to take care over the wording which is very precise. The question requires discussion of issues relating to the effectiveness of internal controls, and it is not on the general issue of what is meant by internal control, or broader aspects of corporate governance.
Key responsibilities requires discussion of the board's role in appointing an audit committee and establishing an internal audit function to assess control effectiveness. The part on methods requires discussion of the way in which internal control is managed, and its relationship to the Audit Committee and Board of Directors. In reporting on regulations it is not adequate to simply mention the existence of the Combined Code and Sarbanes Oxley. The question requires discussion of the requirement to report on the completion of an internal control review.

Marking Guide	**Marks**
Report format and style	5
Key responsibilities	5
Discussion of internal audit and audit committee roles re effectiveness	10
Discussion of the regulations on what has to be reported re internal control effectiveness	5

Examiner's Comments

It was pleasing to see so many candidates getting good marks for the report format and style.

However the candidates strayed from what was asked in the question.

Common Errors

Many candidates did not discuss the effectiveness of internal control. This was the key requirement of the question. Many candidates discussed internal audit and audit committees in detail, but this did not answer the question. Marks were generally poorer than expected for this question

Again candidates must read the questions carefully and make sure they answer what is asked.