

Professional Level – Essentials Module

# Governance, Risk and Ethics

Wednesday 12 June 2013



**Time allowed**

Reading and planning: 15 minutes

Writing: 3 hours

This paper is divided into two sections:

Section A – This ONE question is compulsory and MUST be attempted

Section B – TWO questions ONLY to be attempted

**Do NOT open this paper until instructed by the supervisor.**

**During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.**

**This question paper must not be removed from the examination hall.**

The Association of Chartered Certified Accountants

# Paper P1

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The question paper begins on page 3.**

## Section A – This ONE question is compulsory and MUST be attempted

- 1 A report was recently published by an international accounting organisation on the future of certain rare chemicals used in industrial processes. The report said that some of these chemicals, crucial to many industrial processes, were now so scarce that there was a threat to supply chains for items such as computer circuitry and the rechargeable batteries used in electronic goods. One of these scarce and rare chemicals, the highly toxic trans-Y13 (TY13), has become increasingly rare and, therefore, very expensive. It requires careful processing and, although used in small quantities in each product, its high cost means that even small inefficiencies in its treatment can disproportionately affect final product costs.

The report's conclusions included this statement: 'Put simply, we are living beyond the planet's means. Businesses that use these materials will experience new risks. It may even become seen as socially unacceptable to use some of these materials. Finally, if supply stops, then manufacturing stops.'

One company which depends on a continuous and reliable supply of TY13 is Hoppo Company. Hoppo is a listed company based in the highly developed country of Essland. It has, for several years, designed and developed its products in Essland and then outsourced manufacturing to another company, Red Co, which is based in the developing country of Teeland. This means that Red Co manufactures Hoppo's products for an agreed price and to Hoppo's designs and technical specifications.

Because Red Co is based in Teeland (a developing country with lower land and labour costs than Essland), working with Red Co has offered Hoppo cost advantages over manufacturing its products in its home country. As a company which outsources many of its functions, Hoppo tries to ensure that in each case of outsourcing, working conditions and environmental responsibility are the same at each outsourcing company as they would be if carried out in its highly-regulated home country of Essland.

Hoppo itself is one of the most valuable companies on the Essland stock exchange and has strategically positioned itself as a company that is seen as a trustworthy and responsible producer, that is also responsible in its social and environmental behaviour. In its press statements and annual reports, it has frequently highlighted the high value it places on integrity and transparency as fundamental values in its corporate governance. It has recently considered producing an annual environmental report, as it believes its shareholders would value the information it contains.

Red Co is an experienced producer of electronic circuits and has a long history of working with TY13. It has relationships with the main TY13 suppliers going back many years, and these relationships ensure that it can normally obtain supplies even during periods when world supply is short. Because the supply quality of TY13 varies widely, Red Co has developed finely-tuned methods of ensuring that the TY13 received is of suitable quality. The performance of the finished product is very sensitive to the quality of the TY13 and so this pre-production testing is considered vital. In addition, TY13's toxicity and high cost mean that other systems are put in place at Red Co to ensure that it is safely stored until needed for manufacture.

Earlier this year, however, two issues arose at Red Co which caused Hoppo to reconsider its outsourcing relationship. The first one was the publication of an international media report showing evidence that, despite Hoppo's claims about having the same working conditions at all of its outsourcing clients, labour conditions were unacceptably poor at Red Co. Because labour regulations were less stringent in Teeland, Red Co had been forcing employees to work excessively long hours without breaks, and other measures that would not have been permitted in Essland. It was reported that workers were being bullied, and threatened with dismissal if they complained about their working conditions.

The second problem was a leakage of unprocessed TY13 from the Red Co factory. Not only was this seen as wasteful and careless, it also poisoned a local river, killing many fish and contaminating local farmland. The community living nearby said that it would be unable to use the contaminated land for many years and that this would affect local food supply.

When a journalist, Bob Hob, discovered information about these two issues, the media interpreted the story as a problem for Hoppo, partly because of its reputation as a responsible company. Hoppo's own research had shown that many of its customers valued its environmental reputation and that some of its key employees were attracted to Hoppo for the same reason.

Some important customers began to associate Hoppo directly with the problems at Red Co, even though it was Red Co which had actually been responsible for the employee issues and also the TY13 leak. Hoppo's share price fell when some investors considered the problems to be important enough to undermine future confidence in Hoppo's management and brand value.

In an effort to protect its reputation in future, Hoppo began to review its outsource arrangement with Red Co. The board considered the options for taking manufacturing under its own direct control by building a new factory in another low-cost country, which would be owned and operated by Hoppo. It quickly realised that stopping the outsourcing relationship with Red Co would mean the loss of about 1,000 jobs there and could also raise the likelihood of legal action by Red Co against Hoppo for loss of contract. As Hoppo's manufacturing contract is so valuable to Red Co, some people thought it likely that Red Co would sue Hoppo for loss of future earnings, despite the terms of the contract being legally ambiguous. This lack of clarity in the contract arose because of differences in Essland and Teeland law and as a consequence of poor legal advice that Hoppo received when drawing up the contract. It was believed that any legal action would be widely reported because of Hoppo's international profile and that this may result in some unfavourable publicity.

When considering its options for a directly-owned factory, Hoppo's plan was to build a modern and efficient plant with 'state of the art' environmental controls. Yuland was chosen as a suitable country and Hoppo narrowed the choice down to two possible sites in Yuland for its new factory: Ootown and Aatown. The mayors of both towns wrote to Hoppo's chief executive saying that they would welcome any potential investment from Hoppo. In addition, the mayor of Ootown asked for a 'personal gift' (relatively immaterial although not a trivial amount to Hoppo but a large amount of money locally) to facilitate a trouble-free passage of the necessary planning permission for a new Hoppo factory in the town.

When deciding between Ootown and Aatown in Yuland, the general view was that, all other things being equal, Ootown was a better location. But there was some discussion about whether the 'personal gift' requested by the mayor of Ootown was ethical. The board thought that the decision was an important one and so took some time to reflect before reaching a decision on whether to continue with Red Co or to build a new factory in either Ootown or Aatown.

Having become aware that investing in Ootown and paying the money to its mayor was being considered by Hoppo, a member of the chief executive's office staff informed the journalist, Bob Hob, and a story appeared in an Essland national newspaper saying, 'Hoppo considers paying a bribe to get preferred site in Yuland.' Bob Hob made remarks challenging Hoppo's claims about integrity and transparency, and suggested that recent events had shown that it had demonstrated neither. Public discussion then took place on the internet saying that Hoppo, previously considered a highly ethical company, had been corrupt and incompetent, both in allowing Red Co to breach employment and environmental best practice, and then to consider paying a bribe to the mayor of Ootown.

It was decided that, in seeking to restore its reputation, the company needed to publish a detailed press statement responding to the issues raised in the media. Because Hoppo's reputation for integrity and transparency were considered to be strategically important and had been questioned, it was decided that the statement should also contain reassurances about these important themes.

**Required:**

- (a) Briefly explain 'related' and 'correlated' risks. Explore the correlation between legal risk and reputation risk for Hoppo if it were to cancel its contract with Red Co. (10 marks)
- (b) Describe an environmental report, including its purpose and contents, and discuss the potential advantages of an environmental report for Hoppo and its shareholders. (10 marks)
- (c) Briefly explain how internal controls can be strategic in nature. Explain, using detailed examples from the case, why developing sound internal controls over the supply and processing of TY13 would be important if Hoppo opted to build its own factory in Yuland. (10 marks)
- (d) Draft the press release as discussed in the case. It should:
- (i) Define and explain the importance of 'integrity' and 'transparency' in the context of the case. (6 marks)
- (ii) Construct an argument against paying the bribe to the mayor of Ootown from both business and ethical perspectives. Your ethical arguments should include both deontological and consequentialist perspectives. (10 marks)

Professional marks will be awarded in part (d) for the format, tone, logical flow and persuasiveness of the press release. (4 marks)

**(50 marks)**

**Section B – TWO questions ONLY to be attempted**

- 2 When Blup Co (a listed company involved in water supply) decided to establish an internal audit function, in line with new listing rules, the board approached Karen Huyer, an external consultant. She explained that internal audit is especially important in highly regulated industries but that it could also offer benefits to companies regardless of the industry context.

Karen was particularly keen to talk to John Xu, the head of the audit committee. John explained that because Blup Co was a water supply company and was thus highly regulated, he considered it important that all of the members of the audit committee were professional water engineers so that they fully understood the industry and its technical challenges. All three members of the audit committee were non-executive directors and all were recently retired members of the Blup executive board. When Karen asked about the relationship with external auditors, John said that they had an 'excellent' relationship, saying that this was because the external audit practice was run by the chairman's son-in-law.

Karen said that one of the essential functions of internal audit is to provide assurance that the internal controls which underpinned financial reporting are effective. She said that effective internal controls are necessary for maintaining the integrity of financial reporting and that the new internal audit function could help with that.

**Required:**

- (a) **Discuss the importance of internal audit in a highly regulated industry such as the water industry that Blup Co operates in.** (7 marks)
- (b) (i) **Criticise the ways in which Blup Co's audit committee has failed to meet best practice.**  
(ii) **Explain why the audit committee is responsible for overseeing the internal audit function.**

The total marks will be split equally between each part. (12 marks)

- (c) **Discuss how effective internal controls can provide assurance on the integrity of financial reporting.** (6 marks)

**(25 marks)**

- 3** Because of a general lack of business confidence in Dubland, its major banks had severely restricted new lending. This lack of lending extended to small and large businesses, and also to individuals in society. Press statements from the banks often referred to the need to mitigate financial risks and the need to maintain capital adequacy. Over time, the lower lending produced some negative consequences in the wider Dubland economy.

Responding to these problems, the Dubland finance minister remarked that, 'financial risks may not only cause companies to fail but they can also cause problems in wider society. Banks, in particular, need to be more aware of their financial risks than most other sectors of the economy. They have to manage a unique set of risks and I strongly urge the directors of banks to institute robust risk management systems as part of their corporate governance.

'As finance minister, however, I also believe that banks have a vital role in supporting the economic strength of this country. They hold cash deposits and make short and long-term loans, which are vital to other businesses. Taking risks is a normal part of all business operations and our banks need to accept this risk when it comes to lending.'

Ron Ng, the chief executive of BigBank, Dubland's largest bank, said that continuous and ongoing risk assessment was necessary. He said that despite the finance minister's call for higher lending, his only duty was to BigBank's shareholders and it was this duty that guided BigBank's reduced lending.

**Required:**

- (a) **Explain the meaning of 'risk assessment' as used by Ron Ng and discuss, in the context of the case, the need for risk assessment to be 'continuous and ongoing'.** (8 marks)
- (b) Ron Ng believed that his 'only duty' as BigBank's CEO was to the BigBank shareholders.

**Required:**

**Describe 'fiduciary duty' in the context of the case and critically evaluate the issues raised by Ron Ng's belief.** (7 marks)

- (c) **Explain the term 'financial risk' and discuss how management of these risks can be embedded in a large organisation such as BigBank.** (10 marks)

**(25 marks)**

4 In early 2013, the remuneration committee of Boom Co (a listed company) met to determine the rewards for the executive directors. It was the practice of the committee to meet annually to decide on executive rewards for the forthcoming financial year. In line with best practice, the committee was made up entirely of non-executive directors.

When the remuneration committee met, its chairman, Sarah Umm, reminded those present that the committee should comply with the guidance of the relevant code of corporate governance. She read out the section that she believed was most relevant to their discussions.

*'A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance. The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution in view of the risk of an upward movement of remuneration levels with no corresponding improvement in performance. Remuneration for non-executive directors should not include share options or other performance-related elements.'*

She explained that the committee should balance several concerns when setting rewards: the link with performance, market rates and the company's overall strategy. The strategic priority in the next few years, she explained, was to incentivise medium to long-term growth whilst retaining the existing executive board in place as long as possible.

At the end of the meeting, a new member of the committee, Sam South, asked whether there were any performance-related elements of non-executive directors' rewards. Sarah Umm explained that these were only available to executive members of the board in line with the terms of the corporate governance code.

**Required:**

- (a) **Explain what is meant by a 'code of corporate governance' and discuss the general purposes of such a code in listed companies such as Boom Co.** (7 marks)
- (b) **Propose how the components of a reward package might be balanced to 'incentivise medium to long-term growth whilst retaining the existing executive board in place as long as possible.'** (8 marks)
- (c) **Briefly explain the general roles of non-executive directors in a listed company such as Boom Co, and discuss why non-executive directors should not receive performance-related elements in their rewards as Sam South enquired.** (10 marks)

**(25 marks)**

**End of Question Paper**