

Professional Level – Essentials Module

Governance, Risk and Ethics

Wednesday 10 December 2014



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

ACCA

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The question paper begins on page 3.**

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

- 1 Cheapkit is a large clothes retailer in a major developed country. Its business strategy is based around vigorous cost leadership and it prides itself on selling fashionable garments for men, women and children at very low prices compared to its main rivals. For many years, it has achieved this cost leadership through carefully sourcing its garments from developing countries where labour is cheaper and where workplace regulation is less than in its home country.

As a company with a complex international supply chain, the board of Cheapkit regularly reviews its risks. It has long understood that three risks are of particular concern to the Cheapkit shareholders: exchange rate risk, supply risk and international political risk. Each one is carefully monitored and the board receives regular briefings on each, with the board believing that any of them could be a potential source of substantial loss to the shareholders.

For the past decade or so, Cheapkit has bought in a substantial proportion of its supplies from Athland, a relatively poor developing country known for its low labour costs and weak regulatory controls. Last year, 65% of Cheapkit's supplies came from this one country alone. Athland has a reputation for corruption, including government officials, although its workforce is known to be hard-working and reliable. Most employees in Athland's garment industry are employed on 'zero hours' contracts, meaning that they are employed by the hour as they are needed and released with no pay when demand from customers like Cheapkit is lower.

Half of Cheapkit's purchases from Athland are from Cornflower Company, a longstanding supplier to Cheapkit. Owned by the Fusilli brothers, Cornflower outgrew its previous factory and wished to build a new manufacturing facility in Athland for which permission from the local government authority was required. In order to gain the best location for the new factory and to hasten the planning process, the Fusilli brothers paid a substantial bribe to local government officials.

The Fusilli brothers at Cornflower felt under great pressure from Cheapkit to keep their prices low and so they sought to reduce overall expenditure including capital investments. Because the enforcement of building regulations was weak in Athland, the officials responsible for building quality enforcement were bribed to provide a weak level of inspection when construction began, thereby allowing the brothers to avoid the normal Athland building regulations. In order to save costs, inferior building materials were used which would result in a lower total capital outlay as well as a faster completion time. In order to maximise usable floor space, the brothers were also able to have the new building completed without the necessary number of escape doors or staff facilities. In each case, bribes were paid to officials to achieve the outcomes the Fusilli brothers wanted.

Once manufacturing began in the new building, high demand from Cheapkit meant that Cornflower was able to increase employment in the facility. Although, according to Athland building regulations, the floor area could legally accommodate a maximum of 500 employees, over 1,500 were often working in the building in order to fulfil orders from overseas customers including Cheapkit.

After only two years of normal operation, the new Cornflower building collapsed with the loss of over 1,000 lives. Collapsing slowly at first, the number of people killed or injured was made much worse by the shortage of escape exits and the large number of people in the building. As news of the tragedy was broadcast around the world, commentators reported that the weakness in the building was due to the West's 'obsession with cheap clothes'. Cheapkit was criticised as being part of the cause, with many saying that if retailers in the developed world pushed too hard for low prices, this (the collapse of the building) was one consequence of that. In response, Cheapkit's public relations department said that it entered into legal contracts with Cornflower in order to provide its customers with exceptional value for money. Cheapkit said that it was appalled and disgusted that Cornflower had acted corruptly and that the Cheapkit board was completely unaware of the weaknesses and safety breaches in the collapsed building.

One of those able to escape the building was Jess Lui, who was also the leader of a national pressure group 'Protect workers' rights' (PWR) lobbying the Athland government for better working conditions and health and safety practices for workers in the country. Having seen hundreds of people killed and injured in the collapsed building, she believed that although the government could do more, much of the blame lay with Cheapkit and the pressure it continually placed on Cornflower to keep its prices low. Jess questioned whether multinational companies such as Cheapkit should be allowed to exert so much economic pressure on companies based in developing countries. As concern over the state of other workplaces in the developing world became an increasing concern in the media, Miss Lui wrote a letter to the board of Cheapkit, which she also sent to newspapers and other media. Many of the newspapers and television channels reproduced the letter and it became a talking point in many countries because of the issues it raised.

In the letter, she said that Cheapkit was an unethical company because it supplied a market in its home country which was obsessed with cheap clothes. As long as its customers bought clothes for a cheap price, she believed that no-one at Cheapkit cared about how they were produced. She said that the constant pressure on prices had created a culture of 'exploitative wages', including at Cornflower.

Miss Lui received a lot of support after her comments on Cheapkit's accountability. She said that large international companies such as Cheapkit needed to recognise they had accountabilities to many beyond their shareholders and they also had a wider fiduciary duty in the public interest. The defective Cornflower factory in Athland, she argued, would not have existed without demand from Cheapkit, and so Cheapkit had to recognise that it should account for its actions and recognise its fiduciary duties to its supply chain as well as its shareholders.

At the same time as events in Athland unfolded, the business journalists reporting on the events and Cheapkit's alleged complicity in the tragedy also became aware of a new innovation in business reporting called integrated reporting, an initiative of the International Integrated Reporting Council (IIRC). Jess Lui read one article which said that integrated reporting might increase an organisation's accountability and require it to account for a wider set of concerns than was traditionally the case. This new understanding led to her including the following comment in her letter to Cheapkit:

'... as the leader of the PWR, it is always in my interests to gain as much information as possible from Cornflower and the other businesses with which it transacts, including, in this case, Cheapkit. Perhaps the integrated reporting initiative offers the advantage of a wider reporting model for businesses, to include accountability for a much more diverse set of concerns than has been the case in the past. The integrated reporting model appears to substantially enhance the existing business model and it would be in the interests of broader accountability if Cheapkit, and other businesses in the garment supply chain, were to adopt this new reporting approach. Anything that requires businesses to report on their wider impacts on society and the environment is a good thing as far as social pressure groups like PWR are concerned.'

The board of Cheapkit discussed the issues raised by the well-publicised discussion of Miss Lui's open letter and the comments from business journalists about integrated reporting. The board was, in principle, a supporter of the integrated reporting initiative and thought it would be useful to explain its position on a range of issues in a press release.

Required:

- (a) Discuss the stakeholder claims of Cornflower's employees and customers, and how these claims may be in conflict.** (7 marks)
- (b) Explain 'corruption' in the context of the case and discuss how corruption at Cornflower contributed to the collapse of the building and the loss of life.** (10 marks)
- (c) Cheapkit's board believed that its major risks were exchange rate risk, supply risk and international political risk.**

Required:

Explain each of these risks and how each may be of importance to Cheapkit's shareholders. (9 marks)

- (d)** The board of Cheapkit felt that the reputation of the company had been damaged following publication of Jess Lui's letter. It was decided that it should make a public response to her comments and also respond to points about integrated reporting raised by the business journalists, both of which had received a lot of supportive comment in the media.

Required:

Draft a press statement from the board of Cheapkit to include the following content:

- (i) An explanation of Cheapkit's role as a 'corporate citizen' given its international supply chain.** (6 marks)
- (ii) An explanation of 'accountability' and 'fiduciary duty' as used in the case, and a discussion of how these are relevant to Cheapkit using a shareholder or 'pristine capitalist' perspective.** (6 marks)
- (iii) A description of the basic framework of integrated reporting, and the potential benefits to Cheapkit's different stakeholders, of reporting on different capital types.** (8 marks)

Professional marks will be awarded in part (d) for clarity, tone, logical flow and persuasiveness of your statement. (4 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 The independent board of governors (an independent oversight body comprised of local residents, parents and other concerned citizens) of the state-funded Chambon school for 11–16 year old children met to consider its most recent set of public examination results. A key responsibility placed upon the school's governors is the delivery, to its local government authority, of a report on exam performance in a full and timely manner. A report on both the exam results and the reasons for any improvement or deterioration over previous years are required from the governors each year. Accordingly, this annual meeting on exam performance was always considered to be very important. Although the school taught the national curriculum (a standard syllabus taught in all schools in the country) as required of it, the exam results at Chambon had deteriorated in recent years and on this particular occasion, they were very poor indeed. In order to address the weaknesses in the school, Chambon's budget had increased in recent years and a number of new teachers had been employed to help improve results. Despite this, exam performance continued to fall. A recent overspend against budget was funded through the closure of part of the school library and the sale of a sports field.

One member of the board of governors was Sally Murol. She believed that the local government authority might attempt to close Chambon school if these exam results were reported with no convincing explanation. One solution to avoid this threat, she said, was to either send the report in late or to select only the best results and submit a partial report so the school's performance looked better than it actually was. There is no central computerised exam results service in the country in which Chambon is located by which the local authority could establish the exam performance at Chambon school.

A general feeling of the governors' meeting was that perhaps the school needed some new leadership and it was time to remove the existing headteacher. Mr Besse had been in the role for many years and his management style was thought to be ineffective. He was widely liked by staff in the school because he believed that each teacher knew best how to manage their teaching, and so he tried not to intervene wherever possible. Mr Besse had sometimes disagreed with the governors when they suggested changes which could be made to improve exam performance, preferring to rely on what he believed were tried and tested ways of managing his teaching staff. He was thought to be very loyal to longstanding colleagues and had a dislike of confrontation.

Required:

- (a) **Explain, using evidence from the case, the characteristics which identify Chambon school as a public sector organisation and assess how its objectives as a public sector organisation have not been met.** (10 marks)
- (b) **Explain the roles of a board of governors in the governance of Chambon school and discuss, in the context of Sally Murol's suggestion, the importance of transparency in the board of governors dealings with the local government authority.** (9 marks)
- (c) **Discuss the potential advantages to Chambon school of replacing the headteacher in seeking to address its problems.** (6 marks)

(25 marks)

3 New Ideas Company (NIC) was launched early this year as a result of a scientific breakthrough at a university. The company was located in a relatively small regional city, some distance from the main centres of population. Because the initial capital needed was large, the scientists behind the company decided to float the company on the stock exchange and the take up of shares was very good. This meant that the initial capital needs were fully funded. The business itself was highly technical, with many shareholders only weakly understanding the science behind the company. Upon reading the share prospectus, some analysts believed that NIC was a relatively risky business and that it could fail within two years unless a very good management team, including suitable non-executive directors (ideally locally based), was in place.

None of the scientists involved in NIC had any experience of business before and had to learn about the roles of a board and how to effectively run a company. Dr Ranjana Foo, the lead scientist who made the scientific discovery, was thought to be the logical person to become chief executive but she herself questioned her suitability for the role. She said she was happiest working alone and in the quiet environment of her laboratory, and was not inclined to invest valuable time learning about running a business as she was not good at relating to a wide range of people.

Colleagues said of Ranjana that, being a good scientist, she was excellent at detail but sometimes struggled to see the bigger picture on a project. Always popular, however, Ranjana liked to think that all of her colleagues liked her and she tended to avoid confrontation and conflict wherever possible.

One potential director of NIC was an experienced local businessman, Dr Idris. Upon being approached about the position, he said that he may have a conflict of interest because he was a major shareholder in one of the potential suppliers of the capital equipment which NIC would be purchasing.

Required:

- (a) Assess Ranjana Foo's suitability to become chief executive officer (CEO) of New Ideas Company (NIC). Your answer should include an explanation of the roles and personal qualities of a CEO. (10 marks)**
- (b) Explain the benefits, specifically to NIC, of the appointment of 'suitable non-executive directors' and discuss the difficulties which the company may encounter in non-executive recruitment. (9 marks)**
- (c) Explain 'conflict of interest' and briefly discuss how a major shareholding in a potential supplier could be a conflict of interest to Dr Idris were he to become a director of NIC. (6 marks)**

(25 marks)

- 4 After a period of expansion into several overseas markets and some structural decentralisation, Loho Company was considering its internal audit and internal control needs. Although privately owned and therefore not subject to listing rules, Loho's auditors had often suggested that a formal internal audit function would be beneficial.

The launch of several new products and a rapid increase in exports had raised a number of problems at Loho. These included problems in meeting order deadlines, whilst a number of operational constraints had meant that some orders had been delivered to customers late. The increase in overseas business had also, according to Sonja Tan, the financial director, increased the overall risk profile of the business. Credit risk had risen substantially as had a range of risks associated with exporting and overseas investment. In addition to a growth from 150 to 600 employees in its home country, Loho also had recruited a further 200 people overseas in order to facilitate business in those countries.

As part of her continuing professional development (CPD), Sonja Tan, the finance director who was also a professional accountant, had been to a seminar on improving internal controls (IC). She believed that at this point in its growth, Loho could benefit from tighter internal controls. Speaking about this to the board on her return from the seminar, she reminded her colleagues that sound internal controls could only provide 'reasonable assurance' and that any IC system had inherent limitations and could never be totally effective whatever changes were made to improve them. This came as a surprise to some board members who assumed, because internal controls were often very expensive, that they should be guaranteed to be fully effective.

Required:

- (a) **Construct the case for establishing an internal audit function at Loho Company.** (10 marks)
- (b) **Explain the reasons why many internal controls can never be guaranteed to be fully effective and discuss why ICs being 'very expensive' are no guarantee of their effectiveness.** (9 marks)
- (c) The finance director Sonja Tan learned about improved internal controls as part of her continuing professional development (CPD).

Required:

Explain the advantages of continuing professional development (CPD) for professional accountants such as finance director Sonja Tan. (6 marks)

(25 marks)

End of Question Paper