

Professional Level – Essentials Module

Governance, Risk and Ethics

Wednesday 12 December 2012



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

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

1 P&J is a long established listed company based in Emmland, a highly developed and relatively prosperous country. For the past 60 years, P&J has been Emmland’s largest importer and processor of a product named X32, a compound used in a wide variety of building materials, protective fabrics and automotive applications. X32 is a material much valued for its heat resistance, strength and adaptability, but perhaps most of all because it is flexible and also totally fireproof. It is this last property that led to the growth of X32 use and made P&J a historically successful company and a major exporter.

X32 is mined in some of the poorest developing countries where large local communities depend heavily on X32 mining for their incomes. The incomes from the mining activities are used to support community development, including education, sanitation and health facilities in those developing countries. The X32 is then processed in dedicated X32 facilities near to the mining communities, supporting many more jobs. It is then exported to Emmland for final manufacture into finished products and distribution.

Each stage of the supply chain for X32 is dedicated only to X32 and cannot be adapted to other materials. In Emmland, P&J is the major employer in several medium-sized towns. In Aytown, for example, P&J employs 45% of the workforce and in Betown, P&J employs 3,000 people and also supports a number of local causes including a children’s nursery, an amateur football club and a number of adult education classes. In total, the company employs 15,000 people in Emmland and another 30,000 people in the various parts of the supply chain (mining and processing) in developing countries. Unlike in Emmland, where health and safety regulations are strong, there are no such regulations in most of the developing countries in which P&J operates.

Recently, some independent academic research discovered that X32 was very harmful to human health, particularly in the processing stages, causing a wide range of fatal respiratory diseases, including some that remain inactive in the body for many decades. Doctors had suspected for a while that X32 was the cause of a number of conditions that P&J employees and those working with the material had died from, but it was only when Professor Harry Kroll discovered how X32 actually attacked the body that the link was known for certain. The discovery caused a great deal of distress at P&J, and also in the industries which used X32.

The company was faced with a very difficult situation. Given that 60% of P&J’s business was concerned with X32, Professor Kroll’s findings could not be ignored. Although demand for X32 remained unaffected by Kroll’s findings in the short to medium term, the company had to consider a new legal risk from a stream of potential litigation actions against the company from employees who worked in environments containing high levels of X32 fibre, and workers in industries which used X32 in their own processes.

In order to gain some understanding of the potential value of future compensation losses, P&J took legal advice and produced two sets of figures, both describing the present value of cumulative future compensation payments through litigation against the company. These forecasts were based on financial modelling using another product of which the company was aware, which had also been found to be hazardous to health.

	In 5 years \$(M)	In 15 years \$(M)	In 25 years \$(M)	In 35 years \$(M)
Best case	5	30	150	400
Worst case	20	80	350	1,000

The finance director (FD), Hannah Yin, informed the P&J board that the company could not survive if the worst-case scenario was realised. She said that the actual outcome depended upon the proportion of people affected, the period that the illness lay undetected in the body, the control measures which were put in place to reduce the exposure of employees and users to X32, and society’s perception of X32 as a material. She estimated that losses at least the size of the best case scenario were very likely to occur and would cause a manageable but highly damaging level of losses.

The worst case scenario was far less likely but would make it impossible for the company to survive. Although profitable, P&J had been highly geared for several years and it was thought unlikely that its banks would lend it any further funds. Hannah Yin explained that this would limit the company’s options when dealing with the risk. She also said that the company had little by way of retained earnings.

Chief executive officer, Laszlo Ho, commissioned a study to see whether the health risk to P&J workers could be managed with extra internal controls relating to safety measures to eliminate or reduce exposure to X32 dust. The confidential report said that it would be very difficult to manage X32 dust in the three stages of the supply chain unless the facilities were redesigned and rebuilt completely, and unless independent breathing apparatus was issued to all

people coming into contact with X32 at any stage. FD Hannah Yin calculated that a full refit of all of the company's mines, processing and manufacturing plants (which Mr Ho called 'Plan A') was simply not affordable given the current market price of X32 and the current costs of production. Laszlo Ho then proposed the idea of a partial refit of the Aytown and Betown plants because, being in Emmland, they were more visible to investors and most other stakeholders.

Mr Ho reasoned that this partial refit (which he called 'Plan B') would enable the company to claim it was making progress on improving internal controls relating to safety measures whilst managing current costs and 'waiting to see' how the market for X32 fared in the longer term. Under Plan B, no changes would be made to limit exposure to X32 in the company's operations in developing countries.

Hannah Yin, a qualified accountant, was trusted by shareholders because of her performance in the role of FD over several years. Because she would be believed by shareholders, Mr Ho offered to substantially increase her share options if she would report only the 'best case' scenario to shareholders and report 'Plan B' as evidence of the company's social responsibility. She accepted Mr Ho's offer and reported to shareholders as he had suggested. She also said that the company was aware of Professor Kroll's research but argued that the findings were not conclusive and also not considered a serious risk to P&J's future success.

Eventually, through speaking to an anonymous company source, a financial journalist discovered the whole story and felt that the public, and P&J's shareholders in particular, would want to know about the events and the decisions that had been taken in P&J. He decided to write an article for his magazine, *Investors in Companies*, on what he had discovered.

Required:

- (a) **Define 'social footprint' and describe, from the case, four potential social implications of Professor Kroll's discovery about the health risks of X32.** (10 marks)
- (b) **Describe what 'risk diversification' means and explain why diversifying the risk related to the potential claims against the use of X32 would be very difficult for P&J.** (10 marks)
- (c) As an accountant, Hannah Yin is bound by the IFAC fundamental principles of professionalism.

Required:

Criticise the professional and ethical behaviour of Hannah Yin, clearly identifying the fundamental principles of professionalism she has failed to meet. (9 marks)

- (d) **Writing as the journalist who discovered the story, draft a short article for the magazine *Investors in Companies*. You may assume the magazine has an educated readership. Your article should achieve the following:**
 - (i) **Distinguish between strategic and operational risk and explain why Professor Kroll's findings are a strategic risk to P&J;** (8 marks)
 - (ii) **Discuss the board's responsibilities for internal control in P&J and criticise Mr Ho's decision to choose Plan B.** (9 marks)

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

(50 marks)

Section B – TWO questions ONLY to be attempted

- 2 After a recent financial crisis in the country of Oland, there had been a number of high profile company failures and a general loss of confidence in business. As a result, an updated corporate governance code was proposed, with changes to address these concerns.

Before the new code was published, there was a debate in Oland society about whether corporate governance provisions should be made rules-based, or remain principles-based as had been the case in the past. One elected legislator, Martin Mung, whose constituency contained a number of the companies that had failed with resulting rises in unemployment, argued strongly that many of the corporate governance failures would not have happened if directors were legally accountable for compliance with corporate governance provisions. He said that 'you can't trust the markets to punish bad practice', saying that this was what had caused the problems in the first place. He said that Oland should become a rules-based jurisdiction because the current 'comply or explain' was ineffective as a means of controlling corporate governance.

Mr Mung was angered by the company failures in his constituency and believed that a lack of sound corporate governance contributed to the failure of important companies and the jobs they supported. He said that he wanted the new code to make it more difficult for companies to fail.

The new code was then issued, under a principles-based approach. One added provision in the new Oland code was to recommend a reduction in the re-election period of all directors from three years to one year. The code also required that when seeking re-election, there should be 'sufficient biographical details on each director to enable shareholders to take an informed decision'. The code explained that these measures were 'in the interests of greater accountability'.

Required:

- (a) **Examine how sound corporate governance can make it more difficult for companies to fail, clearly explaining what 'corporate governance' means in your answer.** (10 marks)
- (b) Martin Mung believes that Oland should become a rules-based jurisdiction because the current 'comply or explain' approach is ineffective as a means of controlling corporate governance.

Required:

- Explain the difference between rules-based and principles-based approaches to corporate governance regulation, and argue against Martin Mung's belief that 'comply or explain' is ineffective.** (8 marks)
- (c) **Explain what 'accountability' means, and discuss how the proposed new provisions for shorter re-election periods and biographical details might result in 'greater accountability' as the code suggests.** (7 marks)

(25 marks)

3 In Yaya Company, operations director Ben Janoon recently realised there had been an increase in products failing the final quality checks. These checks were carried out in the QC (quality control) laboratory, which tested finished goods products before being released for sale. The product failure rate had risen from 1% of items two years ago to 4% now, and this meant an increase of hundreds of items of output a month which were not sold on to Yaya's customers. The failed products had no value to the company once they had failed QC as the rework costs were not economic. Because the increase was gradual, it took a while for Mr Janoon to realise that the failure rate had risen.

A thorough review of the main production operation revealed nothing that might explain the increased failure and so attention was focused instead on the QC laboratory. For some years, the QC laboratory at Yaya, managed by Jane Goo, had been marginalised in the company, with its two staff working in a remote laboratory well away from other employees. Operations director Ben Janoon, who designed the internal control systems in Yaya, rarely visited the QC lab because of its remote location. He never asked for information on product failure rates to be reported to him and did not understand the science involved in the QC process. He relied on the two QC staff, Jane Goo and her assistant John Zong, both of whom did have relevant scientific qualifications.

The two QC staff considered themselves low paid. Whilst in theory they reported to Mr Janoon, in practice, they conducted their work with little contact with colleagues. The work was routine and involved testing products against a set of compliance standards. A single signature on a product compliance report was required to pass or fail in QC and these reports were then filed away with no-one else seeing them.

It was eventually established that Jane Goo had found a local buyer to pay her directly for any of Yaya's products which had failed the QC tests. The increased failure rate had resulted from her signing products as having 'failed QC' when, in fact, they had passed. She kept the proceeds from the sales for herself, and also paid her assistant, John Zong, a proportion of the proceeds from the sale of the failed products.

Required:

- (a) Explain typical reasons why an internal control system might be ineffective.** (5 marks)
- (b) Explain the internal control deficiencies that led to the increased product failures at Yaya.** (10 marks)
- (c) Discuss the general qualities of useful information, stating clearly how they would be of benefit to Mr Janoon, and recommend specific measures which would improve information flow from the QC lab to Mr Janoon.** (10 marks)

(25 marks)

4 Railway Development Company (RDC) was considering two options for a new railway line connecting two towns. Route A involved cutting a channel through an area designated as being of special scientific importance because it was one of a very few suitable feeding grounds for a colony of endangered birds. The birds were considered to be an important part of the local environment with some potential influences on local ecosystems.

The alternative was Route B which would involve the compulsory purchase and destruction of Eddie Krul's farm. Mr Krul was a vocal opponent of the Route B plan. He said that he had a right to stay on the land which had been owned by his family for four generations and which he had developed into a profitable farm. The farm employed a number of local people whose jobs would be lost if Route B went through the house and land. Mr Krul threatened legal action against RDC if Route B was chosen.

An independent legal authority has determined that the compulsory purchase price of Mr Krul's farm would be \$1 million if Route B was chosen. RDC considered this a material cost, over and above other land costs, because the projected net present value (NPV) of cash flows over a ten-year period would be \$5 million without buying the farm. This would reduce the NPV by \$1 million if Route B was chosen.

The local government authority had given both routes provisional planning permission and offered no opinion of which it preferred. It supported infrastructure projects such as the new railway line, believing that either route would attract new income and prosperity to the region. It took the view that as an experienced railway builder, RDC would know best which to choose and how to evaluate the two options. Because it was very keen to attract the investment, it left the decision entirely to RDC. RDC selected Route A as the route to build the new line.

A local environmental pressure group, 'Save the Birds', was outraged at the decision to choose Route A. It criticised RDC and also the local authority for ignoring the sustainability implications of the decision. It accused the company of profiting at the expense of the environment and threatened to use 'direct action' to disrupt the building of the line through the birds' feeding ground if Route A went ahead.

Required:

- (a) Use Tucker's 'five question' model to assess the decision to choose Route A. (10 marks)
- (b) Discuss the importance to RDC of recognising all of the stakeholders in a decision such as deciding between Route A and Route B. (8 marks)
- (c) Explain what a stakeholder 'claim' is, and critically assess the stakeholder claims of Mr Krul, the local government authority and the colony of endangered birds. (7 marks)

(25 marks)

End of Question Paper