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# Answers

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1 (a) Family and listed companies

A family business, when incorporated as a company, is an example of a private limited company. This means that the shares are privately held and are not available for members of the investing public to buy and sell. This is in contrast to a public company, which is listed on a stock exchange and in which members of the public, including private and institutional shareholders, can purchase or sell shares. Being a public listed or public limited company carries a number of requirements, imposed either by statute or the stock exchange, which do not apply to private companies. These requirements include compliance with a number of corporate governance provisions which include the adoption of certain governance structures, adherence with internal control and internal audit standards, and the external reporting of some types of information. A private limited company, in contrast, must comply with company law and tax regulations, but is not subject to listing rules.

Mr Mara's behaviour was highly unethical and also illegal, given the regulatory regime controlling surgical supplies in the country in which he was based. His abuse of his office as CEO of Lysus was made possible by a number of failures, linked in part to the nature and culture of the company.

The first such factor was the 'tight-knit' family culture which enabled the decision to be made and then go *unchallenged among the senior management* including his wife, brother and Amy Tsang. The unwillingness to appoint from outside meant that senior members of the company became familiar with Mr Mara's management style and may, over time, have come to consider his behaviour as 'normal'. The fact that Mr Mara was such a domineering figure may have become accepted rather than challenged by other directors, partly because of family ties and their prior knowledge of his character and management style. The fact that the company was family-dominated may have made it difficult for others to confront Mr Mara about his style as such an approach may have negatively affected family relationships.

Being a family or 'insider' dominated business meant that the company did not have any external shareholders. This means that there was *no need to account to public shareholders* for either the performance of the company or its postures on such issues as ethics. External scrutiny of board performance was not present and Mr Mara was therefore not subject to questioning from anybody outside of the company who might have had a different view on his management than the other members of the company.

Because it was not a listed company, there was *no regulatory necessity for Lysus to employ governance structures and systems capable of detecting* and challenging his irregular behaviour. Had Lysus had, for example, an internal control system which included a control over inbound materials or product design, the replacement of the surgical-grade material with industrial-grade would have been detected and an alert raised as it would have not have been in compliance with the regulations on surgical supplies. Likewise, a formal internal audit system would have been capable of investigating any regulatory non-compliance. This could have then been reported in internal reports and, if deemed necessary, to external authorities.

A criticism common to many family-controlled companies is the *lack of external expertise in the form of an effective non-executive presence*. Although some companies employ non-executive directors (NEDs) on a voluntary and 'best practice' basis, the private company status of Lysus usually means that there is no regulatory requirement to do so. The purposes of NEDs in a listed company are to represent the strategic interests of shareholders and to populate the main board committees. These committees, in turn, provide a level of assurance to shareholders of probity, transparency and robustness.

(b) Criticise Amy Tsang's behaviour

The case describes three ways in which Amy Tsang acted in a manner inconsistent with her status as a qualified accountant. Although described by the case as being in her first senior role as finance director, this was no excuse for acceding to the demands of the overbearing and bullying Mr Mara. Her lack of professionalism was one of the factors which led to the failure of some of the replacement joints and the human suffering which resulted.

In the first instance, and in response to a request from Mr Mara, *she performed accounting calculations for the change to industrial-grade materials based on what she knew were illegal materials*, unauthorised for the use in surgical joint replacements. This involved calculating the costings and their effects on company profits, and the size and nature of the factory retooling necessary to make the change. As a senior manager in the company, her correct response, when confronted with such a request, should have been to challenge Mr Mara, clearly reminding him that such a change would be both illegal and unethical since it is stated that she was fully aware of this.

Once her calculations had been considered and the effects on profits ascertained, she used her position as finance director to *sign off (approve) the investment needed to change the manufacturing process* to enable the inferior material to be used. This was a breach of trust conceivably even more serious than the calculations because she approved an investment knowing it would commit the company to the continued use of an illegal material. In retooling the factory so it was capable of using the industrial-grade material, she knowingly approved an action she knew to be illegal. This is a serious breach of the probity expected of a professional accountant.

The third way in which Amy Tsang acted unethically was to *sign the compliance reports to the medicines regulator* to say that all of the materials and manufacturing were compliant with the licence granted to the company to produce the replacement joints. Mr Mara was equally complicit in this, of course, but as a qualified accountant, professionally bound to the ethical code of such a professional person, this was an act of professional negligence on her part.

### Against the public interest

All professionals, including professional accountants, have a primary duty to the public interest. Professionals enjoy a privileged position of high esteem in society, and in return, it is important that they act in such a way as to maintain that position of trust. This includes a commitment to high social values such as human welfare, fairness, justice, integrity and probity, and the wellbeing of society.

In this case, Amy Tsang acted against the public interest in three important ways. First, her actions *facilitated the manufacture and use of products which were illegal and unauthorised*. These failed to comply with relevant regulations and so the accountant was complicit in illegal actions. Absolute legal compliance is assumed for all professionals and Amy Tsang failed on several counts to live up to this expectation and duty.

Second, because the inferior material was hazardous to the health of some of those who had joint replacements, *her actions also meant that many people became ill and some died*. The public interest is concerned with the maximisation of benefit to society and a reduction in health is clearly a breach of that trust. In the interest of what Mr Mara considered higher profits (although this ultimately proved to be misplaced), Amy Tsang took actions clearly to the detriment of Lysus's customers and undermined their trust in the company. It may also have increased society's mistrust of surgical suppliers generally, and this may have other, unforeseen, negative consequences.

Her actions partly *undermined society's trust in the accounting profession* and may have slightly reduced the standing of accountants in society. By taking a full part in the deceit, and approving the changes to the sourcing and manufacture of the products, Amy Tsang was complicit in partially reducing society's trust in professionals and this is against the wider public interest. It is important that professionals of all types, including accountants, act in such a way as to maintain society's trust in the professions.

### (c) Risks vary by sector

Risks do not apply equally to all companies. This is because risks are associated with particular activities, and companies in different industrial sectors are exposed to different risks because of what they do. So, for example, banks are more exposed to a range of financial risks whilst manufacturing and mining are usually more concerned with health and safety risks. This means that the risk auditing process, usually beginning with risk identification, will be highly context dependent, with different risks being registered depending upon the activities of companies within each sector.

#### Legal risk in surgical supplies

Companies such as Lysus, which are involved with the manufacture and distribution of surgical supplies, are exposed to certain risks *because of their strategic positioning and main activities*. Surgical supply companies are engaged with the *production of goods which can have profound effects on the patients* (for good or bad) and so are positioned quite differently to producers of less health-critical goods such as, for example, stationery supplies. Legal risk is the risk, to a company or individual, of legal action against it. This may result from litigation or regulatory sanction for non-compliance with an impact expressed in terms of fines, asset seizure, social disapproval or other legal penalty including imprisonment of individual directors.

When individuals have a surgical procedure, they *expose themselves to a number of vulnerabilities* including the quality of the procedures at the health facility, the skills of the medical staff and the quality (i.e. fitness for purpose) of the replacement devices, if relevant. When the failure of a surgical product, purchased from third parties, causes unnecessary health or mobility problems for a patient, they will often claim that all of the supply chain is accountable for the end result. In the event of any such failure, the patient or his/her family might believe that legal redress is the only way to effectively seek justice for the less-than-successful procedure.

When one or more parts of the process are not fit for purpose, the *effects on the patient can be unfortunate*, perhaps resulting in ill health, immobility or even death. When a cause of a failure can be clearly identified, such as the fracture or premature deterioration of a replacement device because of defective manufacturing or the employment of an inferior material, then the patient may seek legal redress for the pain and distress caused and also the recovery of costs incurred. It is a fact that an individual can be so personally involved in, and by, a failure which makes the legal risk so prominent in the surgical supplies industry.

### (d) (i)

#### Problems at Lysus

Every investor knows that the public listed company form is not guaranteed to be a safe and incorruptible form of business, but some governance initiatives seem to have worked to combat the worst excesses. One of the most prominent is the separation of roles at the head of a company and the introduction of a non-executive chairman. The idea for this came in during the early 1990s and has found its way into most of the world's major corporate governance codes.

I can only wonder how events might have been different had such an effective non-executive chairman been in place at Lysus. It seems that chief executive Mr Mara was able to commit the offences he did precisely because there was nobody in the company able to confront him and keep his irresponsible behaviour in check. A non-executive chairman would be *able to challenge* Mr Mara in a way that no other people in the company were seemingly able to do. The whole purpose of splitting these senior roles is to prevent the investment of unfettered power in a single individual.

In addition, when there is a strong personality like Mr Mara in a private company, it is this person who imprints his or her character on the business culture. An effective non-executive chairman, able to determine the agendas for board meetings and by exercising effective leadership, would be able to *influence the culture and 'tone from the top'*, making

a higher standard of ethical behaviour feel more normal in the company. If staff see their bosses acting unethically and in a dishonest or deceitful way, then it should come as no surprise that this can infect the whole of the company over time.

The presence of a strong figure able to exercise the roles of a chairman would, of course, *improve the governance in any company*. In the case of Lysus, someone whose job it was to *promote openness and debate* about strategic ideas and ensure that *accurate and clear information was freely circulated* in the company could expose misconduct like that demonstrated by Mr Mara. Once ideas are openly discussed, the weaker ones are often criticised and exposed as inadequate. The immunity to criticism which Mr Mara felt, allowed him to believe he could get away with using non-compliant materials, but would soon have been rejected had such an effective chairman been in place.

The sad case of Amy Tsang is a final salutary case in favour of a non-executive chairman. My own view is that she meant well and was a young, ambitious accountant, but she was effectively forced to comply with Mr Mara by his arrogance and bullying. The presence of a non-executive chairman *would have given her, and other concerned directors, someone to communicate with about their concerns and give them someone to confide in*. With Mr Mara being her only superior manager in the company, she was effectively forced to comply with Mr Mara or leave the company. In hindsight, it would have been better for her if she had left, but that point is irrelevant now.

## (ii) Embedding risk awareness

I know it is a bit late to offer advice to Lysus but as someone who has seen several stories like Lysus's in the past, it is worth reminding readers about how situations like this can be avoided. When business risks – those capable of *threatening the entire business as a going concern* – are realised, the effects are always very unfortunate for those involved. They are often big enough to threaten the business either by a loss of sales or, as in this case, by making the company non-compliant with the regulatory systems which underpin society's trust in the surgical equipment industry.

For those other businesses wrestling with issues such as this, here is the summary of my experience and my advice on improving probity risk awareness. Investments work when we can trust the integrity of directors. When this cannot be assumed, trust in business investments will rapidly deteriorate. As an investment community, these risk-embedding practices should be encouraged in all businesses, whether they are large and listed, or smaller and private.

The whole idea, in my view, is to embed all risk awareness into the normal operations of the company. This means that nothing is 'bolted on' but that all employees are expected to be risk aware at all times. One of the first ways of achieving this is to establish a *visible policy on risk awareness*, and have this unreservedly supported by management, trade unions and staff. This should encourage everybody to identify risks, including those arising from the behaviour of management, and bring them to the attention of appropriate people without fearing a negative or hostile response. A philosophy and culture of risk awareness would be developed so that everybody recognises the importance of all risks and seeks to address them as far as possible.

Linked to this is the encouragement of *open communication and a supportive culture*. No-one should think themselves too junior or uninformed to raise a risk issue with management. It is often at the operational levels where risks can have the most unfortunate effects and so many previously unnoticed risks can arise from there. Similarly, management should welcome all discussion of risk as a normal part of their responsibilities and should never dismiss an idea, even if it is something of which management is already aware. It should not be forgotten that it was because of Mr Mara's lack of probity that the employees of the company lost their jobs: their stake in the company was the security of their jobs, and those jobs are now gone.

It is always good practice to establish formal systems such as a risk committee and a risk auditing procedure. The *establishment of a risk audit* forces the company to identify all risks affecting the business, both internal and external. Once listed on a risk register, each of these can then be assessed according to their perceived probability of being realised and their likely impact. A risk strategy can then be assigned to each risk and any changes to the risk environment can be 'fed' into the system to ensure that it remains current. This also provides a reporting mechanism by which individual managers, including the most senior, can be held accountable for their behaviour in respect of risks. Had Mr Mara known that this probity risk had already been identified and assessed by the risk committee, the outcome may have been very different.

Such risk management systems work when they are embedded into *human resource systems* such as job descriptions and appraisals. If the reporting and management of key risks are treated as a standing item in job descriptions and then considered annually as part of staff appraisals, it will soon become normalised into employees' work roles, and will be considered nothing out of the ordinary. If integrity failures were made something which would attract summary dismissal, for example, the ethical tone in the company may have been improved.

A final way to embed risk awareness in general is to *publicise success stories* in the company and to *reward risk awareness behaviour* through whatever mechanisms are appropriate. It would be welcomed if the discovery of a new risk or a change in its assessment was something which employees thought to be an exciting thing and something which might attract an additional day's holiday, a one-off cash payment or a weekend break away somewhere.

I wish the situation at Lysus were different. It is a sorry tale and I only hope that the lessons can be learned by other businesses.

## 2 (a) Private and institutional shareholders

Shares in public listed companies are held by a range of individuals and institutions. In most stock exchanges, it is convenient and relatively cheap to buy or sell shares (usually on an internet-based application) and many individual people often buy and sell shares in companies in this way. A second type of shareholder is the institutional shareholder. This is an organisation, rather than an individual, and accordingly, the number of shares held is usually much higher than individual 'private' shareholders hold. Some investors buy shares directly in companies through the stock exchange whilst others purchase a small part of a larger fund, such as that at R&A.

Institutional shareholders tend to be large financial institutions with large capital sums and include pension funds, insurance companies, banks, and specialised investment companies. They have many clients buying into a certain fund, such as the one at R&A, and this fund is then managed in some way with the agreement of the clients who have placed money into that fund. The fund attracts a management cost (to pay for the transactions and the fund management costs) which is deducted from the gains (or losses) made.

### Agency issues and institutional shareholders

The agency problem exists whenever there is a separation between the ownership and management of a company. It is called a 'problem' because it is partly the role of management to ascertain the wishes of the shareholders in order to most effectively manage the strategy to maximise shareholder satisfaction.

The agency problems are potentially more complex with institutional shareholders than when private shareholders buy shares directly in companies.

Because R&A owns shares on behalf of clients, the final shareholders are *one stage removed from the shareholdings*. In other words, the R&A clients might find it more difficult to convey their preferences to the companies they hold shares in and must effectively delegate this responsibility to the fund manager employed by R&A. This means that individuals or organisations who buy into R&A funds do not receive company information for each of the shares held by the fund and not everything which the individual companies do may meet with the expectations of each client of the fund. In addition, it is difficult for the boards of those companies to determine the wishes of the clients because they are 'concealed' behind the fund manager and the confidentiality systems of R&A.

There are many shareholders who are members of each fund. Although it is likely that they all share the general objective of capital growth, *there may be disagreements on corporate social responsibility (CSR) matters* such as the extent to which R&A should be investing in house building companies in order to deliver a certain social good. A shareholder seeking, for example, to maximise long-term returns might not see the purchase of the house builder as a priority or necessarily one which can add most value to their portfolio. In this regard, because the R&A client is a member of the R&A fund, no client would have a direct voice in supporting or challenging company policy (on CSR or on other strategic matters such as the purchase of Natcon).

The shares held in a certain fund might change over time as some shares are purchased and others are divested by the fund manager. This means that the client (the investor in the fund) *might not know the identity of the companies the fund is currently holding*. Unless the investor is very active, by say, checking the composition of the fund on a weekly basis (usually on the internet), it is likely that they would not know which shares they indirectly own and this would restrict their ability to hold principals to account, even if this was their intention and desire.

## (b) Distinguish between CSR strategy and strategic CSR

To have a strategy for CSR is to have a set of policies which guide and underpin CSR activities. This means that some causes or areas of activity are favoured over others, in line with the strategy adopted. So, for example, a company might have a policy to invest in some communities or charitable causes and not others. The policy or strategy may be agreed based on a number of issues: perhaps the preferences of the employees, the preferences of senior people in a business, or the preferred outcomes may be chosen based on strategic concerns.

When CSR is undertaken to maximise its effects on the long-term economic benefit of the business, it can be described as strategic CSR. When CSR activities are strategic, they generally support the main business areas of the business. So a financial company such as a bank might favour financial education causes whilst a medical supplies company might prefer medical or nursing research causes or overseas medical efforts. It would be seen as strategically wasteful to use CSR to support activities which are not aligned to the core activities. An assumption underpinning strategic CSR is that all assets in a company belong to the shareholders and so all activities, including CSR, should be configured in such a way as to support shareholder value.

### Argument that the purchase of the house builder is strategic CSR

The purchase of the house builder is described in the case as a departure from R&A's longstanding strategy of investing in listed companies as part of its holding of passive funds. In arguing that it is nevertheless strategic and therefore in the long-term economic interests of the R&A shareholders, several points can be made.

The case scenario describes a '*shortage of low cost housing*' and whenever demand exceeds supply, prices rise. This has the capacity to make the prices chargeable for the new properties higher than might be expected and the large reserves of land (land bank) are also likely to increase in value over time if demand continues to exceed supply. So although it may be described as a CSR measure by R&A, it is likely that substantial returns may be made on the investment at the same time. Because it serves both ends (CSR and the strategic good), it could be argued to be a good example of strategic CSR.

As with other CSR initiatives, the development of affordable homes may make some *reputational capital for R&A*, especially as it frames its purchase in terms of meeting a social need. If the housing developments are conveyed to the public as R&A exercising its social responsibility, it may increase the company's profile generally, and also enhance the favourable perception by which R&A is viewed. These joint effects may make it more likely that people will invest in R&A either as shareholders or clients, thereby ensuring the company makes an economic return on its CSR.

Because R&A is an investment company which purchases shares but does not control the companies it invests in, the outright purchase of a company represents a *diversification of its business activities*. It could be argued that such a diversification represents a strengthening of the robustness of R&A's business as it means that risk and return become more widely spread.

- (c) Stakeholder claims are the outcomes sought in a given situation by a specific stakeholder. If a stakeholder has a voice (such as a university, a local government authority, a trade union, etc), then the claim can be articulated clearly in terms of which outcome is being sought. If it does not have a voice (such as future generations), then its claim is less certain and the best outcome is not always clear. Stakeholder claims are often in conflict. This means that two stakeholders want different outcomes in a certain situation. The university in the case does not want new housing to be built whilst R&A and the local government authority are both in favour of the development. This is an example of stakeholder claims in conflict because both preferences cannot be accommodated; one must 'win' over the other.

In any stakeholder situation, including those which are in conflict, the influence can be ascertained by the Mendelow matrix. This is one way of mapping the influence of stakeholders. Identified stakeholders are assessed according to their relative power and interest. Those stakeholders with the highest combination of these variables are those with the most influence over outcomes.

The local government authority has a higher structural power than the university because of its *ability to grant or withhold planning consent*. This is a statutory power devolved to local government authorities from central government, although it is usually required that local consultation be entered into before final approval is granted. It also has limited power as a shareholder of R&A and possibly some influence as an investor in R&A's funds. As an external stakeholder being an authority interested in the construction of low cost housing and both a client and a shareholder of R&A, there are considerable conflict issues. It has a social obligation to see the development approved as this will allow lower cost housing to be built where most needed. The local government authority's *interest* in the activities of R&A therefore derives from two sources: its interest in providing low cost housing and its concern for the profitability of the R&A company in which it holds shares.

The university has less power over the planning decision because it has *no statutory power, is not a shareholder in R&A directly and has a lesser investment in R&A's funds than the local authority as an R&A client*. It is likely that the views of such an important local institution would be taken into account, however, because a successful university is important in the development of Housteads as a town. The local government authority must balance the claims of a number of stakeholders when taking decisions of this type, including the economic interests of R&A. The interest of the university is *over the spoiled view from one of its buildings* (sometimes referred to as a visual amenity). The university is of the opinion that the new houses will reduce the view over countryside currently enjoyed. The weight given to the value of the view over and against the social value of the new housing development to the local government authority and the local community is an ethical matter and one which, in this case, seems to have been decided in favour of the development.

### 3 (a) Define independence

Independence is a quality possessed by individuals and refers to the avoidance of being unduly influenced by a vested interest. This freedom enables a more objective position to be taken on issues compared to those who consider vested interests or other loyalties. In the case of the independence of the members of an audit committee, it is important that members are not influenced by the company's finance function or other members of the executive board.

The independence of audit committee members can be threatened by over-familiarity with, for example, executive directors, which is why many corporate governance codes have measures in place to prevent over-familiarity. These include restrictions on share option schemes for non-executive directors (NEDs), time-limited appointments and bans on cross-directorships. Other restrictions, depending on jurisdiction and code, include salaries being set at an appropriate level for NEDs, a compulsory number of years after retirement from a company before being eligible for a NED role (if ever), and no close personal relationships between executives and non-executives.

#### **Independence of audit committee (AC) members**

Independence brings with it a *helpful ignorance* of any factions or points of friction in the company's management of internal control or risk. By bringing a 'fresh pair of eyes' to the important areas of audit committee oversight, the committee can act without bias or prejudice. With an important input into financial reporting, for example, the audit committee needs to ensure the accuracy of reporting and the robustness of the systems supporting that reporting. Without the 'baggage' of knowing the history of a certain system, AC members can assess its fitness for purpose as if assessing the system for the first time.

Members need to be *free of vested interest to act solely in the interests of shareholders* and not of any faction in the company. Members are not representing any particular part of the company (e.g. the board, trade unions or certain interests with which a certain member might have sympathy) but the strategic interests of the shareholders. The audit committee must be able to scrutinise, review and act upon reports on internal controls and internal audit without the fear of upsetting friends or colleagues inside the company who he or she may know informally or through other networks.

The independence of the audit committee members serves to *reassure investors* and other non-executive directors in that it makes the governance of the company appear to be more robust and trustworthy. A key purpose of an audit committee is to provide an independent oversight of important governance systems in a listed company, and shareholders and regulators usually place a high value in having an effective audit committee in place. It is important, then, that it is independent, and seen to be independent, to provide maximum reassurance to shareholders in constraining the potential excesses and vested interests of executive directors.

**(b) Inability to recruit a person with ‘recent and relevant financial experience’**

First, it shows that the *company may be having trouble with compliance* and this is not a good start to the company’s life as a listed company. A shareholder might ask why Hafnium Company was unable to recruit NEDs to ensure compliance with the listing rules. This will negatively affect the shareholders’ perceptions of the competence of the management of Hafnium Company and hence their willingness to invest in the company and trust the board with strategic decisions.

Some of the functions of an audit committee require some financial experience and the committee would not be operating as it should be if this expertise is not available. It needs to *review the annual accounts of the company*, for example, and this requires knowledge of how accounts are constructed and the regulatory framework around this. If this expertise is not present on the audit committee, they will not be able to provide the scrutiny necessary and this opens the company up to potential fraud or error in this important task.

The audit committee also has an important role in the *oversight of the relationship between the company and its external auditors*. Although Sophie Xu has a good understanding of Hafnium Company’s business model (which is very helpful), she does not necessarily understand the nature or importance of this relationship with the external auditor. As a key part of underpinning the shareholders’ trust in the accuracy of the company’s accounting systems and audited accounts, an effective and independent auditor is essential. If Sophie Xu is unable to contribute to this role because of a lack of financial and accounting knowledge, the shareholders’ confidence in the committee will be reduced.

The audit committee also has a role in *receiving reports on internal controls and risk management systems*. It is likely that, as an engineer who understands the Hafnium Company business model, Sophie Xu will be well equipped to understand some of these reports. Her lack of financial experience, however, might mean she is not equipped to understand the internal controls linked to the accounting systems or financial measurements. Likewise, risks arising from financial exposures such as exchange rates, debt to equity, credit and cash flow may be outside her understanding. These risks can substantially threaten shareholder value and the audit committee’s inability to meaningfully process the information could reduce its value to shareholders.

**(c) Nature of the relationship**

It is important that the relationship between the audit committee and the external auditor is appropriate in that it should *not be close and it should be free from any ethical threats to independence*. This means the auditor must have no familiarity threats, self-interest threats or other interests which might compromise its independence.

The audit committee, acting on behalf of the shareholders, needs to ensure the *independence and effectiveness of the external auditor* in its important role as the party providing assurance of financial statements and the systems which support them. The audit committee has the power, in its role as the body overseeing the relationship between the company and the external auditor, to recommend replacement of the auditor if it believes audits are in any way lacking independence or rigour. This means that the audit committee must adopt a *default position of being sceptical* of the external auditor so as to always assure the shareholders of the independence of the relationship at all times.

**Audit committee response to too close a relationship**

There are several possible responses for an audit committee which believes that there may be an inappropriate relationship between the company and the external auditor. It is not uncommon for human relationships between company employees and external auditors to be friendly and cordial, perhaps with accountants in the two organisations having longstanding friendships and professional associations. Depending upon the extent of the perceived threat to independence, the audit committee has several options it can pursue.

Many audit firms, sometimes underpinned by regulation, have a policy in place to rotate the audit staff conducting the audit for a given company. This is to ensure that the engagement partner (the senior auditor overseeing the audit at a certain company) does not become too familiar with the client such that it might threaten the independence of the auditor–client relationship. The simplest way to refresh the relationship and remove the independence threat is for the audit committee to advise the board to liaise with the auditor *to ensure its engagement partner rotation policy is fully effective or request the rotation* of a particular engagement partner if it perceives that the current occupier of that position is too close to a senior person in the company.

Second, the audit committee can recommend to the board that a policy be instituted *where the audit contract goes out to tender every so many years*. Some corporate governance codes provide for this, and the intention in each case is to ensure that the auditor is continuously aware that there is nothing to be gained by investing in the relationship with the client because the contract will be independently awarded every so many years. This not only provides better financial value for the shareholders (audit firms compete, including on price, for the audit contract) but also helps to maintain a certain distance between auditor and client.

In an extreme case, where the audit committee believes that the independence of the auditor is seriously threatened, *the audit committee can recommend the immediate replacement of the auditor*. This is usually considered to be a last resort and it

would only be enacted if serious independence threats were observed and the board was thought to be unresponsive to a resolution on the issue, but it provides shareholders with the assurance that the audit committee can act, on their behalf, to ensure an effective financial audit in each case.

#### 4 (a) Kohlberg's levels of ethical development

Kohlberg's three levels of human moral development are the pre-conventional, the conventional and the post-conventional. Each level is characterised by certain beliefs about what an ethical act is and the extent to which conventional rules and regulations should be observed.

At the conventional level, morality is understood in terms of compliance with either or both of peer pressure/social expectations or regulations, laws and guidelines. A high degree of compliance is assumed to be a highly moral position. A person who is ethically engaged at the conventional level will consider it important to learn the rules and expectations which apply to them and then comply in detail. These can concern legal rules, social norms and accepted standards of behaviour.

At the post-conventional level, morality is understood in terms of conformance with 'higher' or 'universal' ethical principles as perceived by the person being considered. Post-conventional assumptions often challenge existing regulatory regimes and social norms, and so post-conventional behaviour is often costly in personal terms. The nature of the 'higher' ethical principles is subjective and specific to the person.

##### Mary Wong's behaviour

Mary Wong would have been considered conventional if she had considered it an ethical 'good' to comply with her instruction to maintain the confidentiality of the data. The case, however, describes a situation in which *Mary Wong acted according to a post-conventional motive*. Several aspects of her behaviour can be cited in support of this.

She *did not comply with the terms and conditions* of her employment, which would have prevented her from making any information public. The company's preference to keep internal information confidential to itself was presumably intended to prevent too much external scrutiny from local communities whilst maintaining a good performance against environmental targets. A conventional ethical response would have been to have maintained this confidentiality in the belief that compliance with existing rules, regulations and constraints was the ethical good.

But Mary Wong *believed that some things were more important than obeying rules*, however well-intentioned those rules may be. Having taken her concerns to the highest authority in the company and receiving no satisfaction, she judged it a greater good to disregard the constraints of her contractual terms and conditions, and expose what she saw as an injustice to the wider community. Her belief was likely to be concerned with their right to know about how the emissions might affect them, and as someone who had a strong internal motivation for environmental matters, her outrage outweighed her concern for her job.

Mary Wong *paid a high personal price for her actions* by being dismissed from her job. Those acting from a post-conventional motivation often manifest this by disobeying or exceeding existing regulatory constraints (such as by organised disobedience, whistleblowing, etc). It is therefore common for such people to be sanctioned, either by the state, by an employer or by whichever organisation or group is affected by their actions. They assume for themselves an ethical position higher or more important than those of others and, accordingly, often bear the disapproval of the majority.

#### (b) The case for Pulpo to publish an environmental report

Given the recent problems which Pulpo has been having, there is a strong case for increased environmental disclosure directly relating to Pulpo. The first point to make is that the company already gathers data on environmental matters to supply to the parent company for its own group environmental report. This means that the systems must therefore be in place to produce environmental data and so the *marginal costs will be relatively modest*, and mainly concerned with drafting information pages and having them published on the website.

It will increase the appearance of transparency at Pulpo, and help to *repair the damaged relationships with the residents' association and the newspaper*. Mary Wong's disclosures clearly angered these groups and so a lack of trust is likely to exist towards Pulpo as a result. Measures capable of restoring trust and legitimacy include increased disclosure and efforts to increase the transparency of the company, especially to those who have been historically critical of it.

An environmental report framed in terms of explaining the inputs, processes and outputs, including waste, would help Pulpo to *explain its business model* and possibly provide information to address the environmental challenges. These might include *helping to offset criticisms about the smell and the water pollution* which are perceived to be a problem by local residents. If, for example, the company provides a full explanation of why fumes are generated and what those fumes are, whilst perhaps not fully satisfying residents, they may at last understand why they are necessary.

The publication of environmental information may *help to improve the local reputation of Pulpo*, which appears to have had some recent reputation problems. If it wishes to continue to enjoy the support of the local community, from which it presumably draws a lot of its labour, its reputation locally will be important. If a company such as Pulpo begins to lose the implicit or explicit support of the local community, it may suffer in terms of being able to recruit employees and in terms of local support when, for example, building planning permission is needed or similar developments which may have an impact on the local environment.

**(c) Explanation of internal control**

At its simplest, an internal control is any action or system put in place by management which will increase the likelihood that organisational objectives will be met and assets safeguarded. Internal control measures are put in place to control the internal activities in an organisation so that they achieve the purposes intended. By having internal activities co-ordinated and configured appropriately, with means of measuring and reporting on compliance levels, waste (i.e. non value-adding activity) is minimised and efficiencies are gained which increase the effectiveness of the organisation in meeting its strategic purposes.

**Internal controls and environmental footprint**

Internal controls are important in controlling all internal activities, including the systems and procedures which underpin Pulpo's environmental footprint.

One of the most obvious ways in which internal controls are necessary for controlling environmental footprints is in the *operational controls which measure and determine the input consumption and the production of emissions*. It is only by the accumulation of accurate environmental consumption and emissions data that the footprint can be identified and therefore monitored, scrutinised and improved. Internal controls capable of making these measurements (say in terms of energy, water and raw material consumption, and waste emissions) are therefore essential in measuring and therefore controlling the environmental footprint.

Internal controls can also be used in the *management of the plant and equipment* which is used in the production of pulp and paper. The case says that the ageing equipment in the factory is a source of increased emissions, and this implies that the maintenance and replacement cycles of machinery is a major factor in Pulpo's environmental footprint. Internal controls which measure the efficiency of the factory equipment, how much material it consumes and how much waste it produces can be measured. This data, in turn, can be used to adjust maintenance and replacement times to help control the environmental footprint.

Sound internal controls are a key part of the normal efficient management of operations. They are also necessary for producing accurate information upon which regular reporting is based. These make internal controls able to act as an *'early warning system'* for any *inefficiency in environmental systems* which help to control the environmental footprint. By having an effective continuous monitoring of internal systems, there will be an automatic awareness of targets and early signs of any internal threats to the meeting of those targets.

- 1 (a)** Up to 4 marks for distinguishing.  
2 marks for each relevant point on discussion of family-owned business. (Maximum 10 marks)
- (b)** 2 marks for each relevant point of criticism to a maximum of 6 marks.  
2 marks for each relevant point on acting against the public interest to a maximum of 6 marks. (Maximum 10 marks)
- (c)** 2 marks for explanation of risks by sector.  
2 marks for each relevant point on legal risk in the sector. (8 marks)
- (d) (i)** 2 marks for each relevant point made. (8 marks)
- (ii)** 2 marks for each relevant point on 'embedding risk'. (10 marks)
- Professional marks (4 marks)
- 2 (a)** Up to 3 marks for distinguishing between private and institutional.  
2 marks for each relevant point on agency issues. (7 marks)
- (b)** Up to 2 marks each for explanation of CSR strategy and strategic CSR to a maximum of 4 marks.  
Up to 2 marks for each relevant argument. (10 marks)
- (c)** 2 marks for explanation of stakeholder claims in conflict.  
2 marks for evidence of understanding of the Mendelow (power/interest) matrix.  
2 marks for assessment of each of the two stakeholders. (8 marks)
- 3 (a)** Up to 2 marks for definition of independence.  
2 marks for each relevant point on independence of AC members. (8 marks)
- (b)** Up to 2 marks for each relevant point made. (8 marks)
- (c)** 1 mark for each relevant point on appropriate relationship to a maximum of 3 marks.  
2 marks for each relevant point on AC response to a maximum of 6 marks. (9 marks)
- 4 (a)** 4 marks for distinguishing between Kohlberg's levels.  
1 mark for correct identification of the level Mary adopted.  
2 marks for each relevant point of reason. (Maximum 9 marks)
- (b)** 2 marks for each relevant argument made and developed. (8 marks)
- (c)** Up to 2 marks for explanation of internal control.  
Up to 2 marks for each relevant point on IC controlling environmental footprint. (8 marks)