Professional Level – Essentials Module

Governance, Risk and Ethics

Wednesday 10 June 2015

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

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

1 Lysus surgical supplies was founded 20 years ago by entrepreneur Simon Mara who has been the company's chief executive since the outset. Incorporated as a private company, Lysus began by importing small surgical devices such as syringes and bandages, and selling them to hospitals, clinics and medical facilities. But the company began to grow rapidly when Mr Mara realised the potential of a growing market in knee and hip joint replacements as the population in many countries was rapidly ageing due to the wider availability of more effective, low cost medicines. Fifteen years ago, he began to manufacture the surgical hip and knee joints used for most joint replacement surgery. As a company operating in the surgical supplies industry, Lysus has always been subject to regulation and must complete compliance reports every year to declare that it is using surgical grade materials for its manufacturing and also that it maintains the requisite level of hygiene in its processes. These reports are a legal compliance matter and must be signed by two directors.

Lysus surgical supplies has been a private family (or 'insider') company throughout its history. Owned jointly by Simon Mara, his wife and brother, Mr Mara owns 51% of the shares, his wife, 20% and his brother 29%. All three are directors of Lysus surgical supplies. As the company grew, they sought to employ members of the extended family as much as possible, partly to provide them with jobs and partly to 'give a feeling of family' in the company. It was often described as a 'tight-knit' culture with family members occupying the senior positions and with few appointments made from outside the company to important roles. When the company grew to a certain size, Mr Mara decided that he needed a qualified accountant on the board of directors to help with investment appraisals, costings, cash flow management, compliance issues and financial reporting. He eventually appointed Amy Tsang, a relatively inexperienced but ambitious person to the board. This was her first role as finance director.

Simon Mara was known to be a strong and domineering person. Some former employees described him as a bully who was unable to discuss matters in a calm manner. He was described as quick to anger and capable of intimidating even his senior colleagues such that they would feel unable to challenge him at all. This was also the case with Amy Tsang, the new finance director. She found him overbearing and impossible to challenge. She always did as he asked, even when she felt uncomfortable with what she was being asked to do.

When the joint replacement industry became more competitive, Mr Mara had the idea that he could reduce the company's unit costs by switching some of the surgical-grade materials used in manufacture for a cheaper industrial grade instead. Such a switch would be undetectable to the surgeons using the artificial joints but did increase the risk of fracture and deterioration once the replacement joints were used in a patient. Mr Mara asked Amy Tsang, as an accountant and finance director, to produce detailed costing calculations for the switch and to forecast how this change would affect profits. She also calculated the costs of retooling the factory to allow the industrial grade material to be used. Later, on Mr Mara's instruction, she approved the investment and oversaw the changes in manufacturing and the purchasing processes, in the full knowledge that such changes were both illegal and unethical. Mr Mara assumed that because many of the senior employees were family members, and that he could control Amy Tsang, that the switch to industrial grade material would go undetected.

The problem came to the public attention some time later when joints made from the inferior material began to deteriorate and immobilise previously mobile patients. The industrial grade material used in the joints often caused infection in patients and some vulnerable patients died of the effects of the product failure.

John Qua was the investigative journalist who brought the problems at Lysus to national attention. He thought that the problems arose as a result of a probity risk and that the probity or integrity failure was on the part of Mr Mara and Amy Tsang. Mr Qua's mother had received a Lysus hip joint and subsequently experienced a great deal of pain and distress when the joint deteriorated, producing some unfortunate side effects including blood poisoning. Although his mother was able to have the joint safely removed and replaced by a better quality artificial joint, John Qua researched further and found other patients who had not been so fortunate. It was John Qua's investigations into Lysus which alerted the regulatory authorities to the use of the inferior materials in the joints. It soon emerged that the cause of the increased failure of the implants was the use of the inferior industrial-grade material.

When the regulator responsible for the safety of surgical supplies discovered, thanks to John Qua's research, why the joints degraded, they investigated the use of the inferior materials. The legal officers investigating the case noted that two directors had signed the most recent compliance reports, certifying that the company was fully compliant with material usage and quality standards. These were Simon Mara and Amy Tsang.

John Qua was angry with Lysus surgical supplies, because of how his mother and others had suffered. He was particularly angry with Simon Mara and Amy Tsang. As a business journalist, he often wrote articles on the behaviour and performance of listed companies. He became convinced that it was in the public interest for producers of surgical supplies, such as Lysus, to be subject to the regulatory requirements of listed companies. In a published article, he wrote:

…whenever I look at company failures such as that at Lysus, I become increasingly convinced that robust ways of embedding risk awareness and risk management are essential in all companies and not just in listed companies. It was the fact that Mr Mara could get away with his offences that is most worrying. He bullied a young accountant, Miss Tsang, into highly unprofessional behaviour, and without the systems in place to enable the offence to be challenged internally, he initially got away with it. Had a whistleblowing system been in place, or a separation of roles at the head of the company, Mr Mara could not have done this terrible thing. Someone would have challenged him and told him not to be so unethical and arrogant.

The result is that, with such a high impact business risk having been realised, innocent people working for Lysus may lose their jobs whilst patients may have to suffer the effects of this for many years.

Once the case came to the public attention, Mr Mara was arrested and prosecuted for the illegal sale of non-compliant surgical materials. Amy Tsang was also prosecuted and then investigated by her professional accounting body. After an appeal, she was 'struck off', thereby preventing her from working as an accountant in the future. The company itself was wound up after sales declined, and all 130 employees lost their jobs. Patients continue to suffer the effects of the defective joint replacements and will do for several years into the future.

Required:

(a) Distinguish between the governance of a family-owned company like Lysus and a publicly listed company, and explain how Mr Mara may not have committed the offences he did if Lysus had been a publicly listed company. (10 marks)

(b) Criticise Amy Tsang's behaviour as the finance director and a qualified accountant, and explain how she acted against the public interest. (10 marks)

(c) Briefly explain why some risks vary by industry sector and discuss why legal risk might be more relevant to surgical suppliers like Lysus than in some other industry sectors. (8 marks)

(d) Write an article for the specialist magazine *Investors in Companies* which covers the following points. You may assume that the magazine has an educated readership.

(i) Discuss the potential benefits which an effective non-executive chairman could have brought to Lysus. (8 marks)

(ii) Explain, in the context of the case, how risk awareness, including probity risk, might be embedded in a company like Lysus. (10 marks)

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

(50 marks)

Section B – TWO questions ONLY to be attempted

2 Rosey and Atkins (R&A) is one of the largest institutional investors in the country. Its investment strategy has traditionally been to own a minor shareholding in each of the top 200 companies on the stock exchange. The R&A shareholding is typically between 2% and 10% of each company and it manages funds for over two million clients (people and businesses who buy into share funds managed by R&A).

Established over 200 years ago, R&A has always believed itself to be socially responsible. As part of its CSR strategy, R&A recently purchased 100% of the shares in a national housebuilder, Natcon, which it owned as a direct holding and did not include in its managed funds. Natcon, in turn, owned a large amount of land suitable for future low cost housing development. The R&A website reported that the reason for this purchase was to address the board's concerns over a shortage of affordable housing in the country which R&A felt they could help to address by having outright ownership of Natcon. R&A reported that there was a large social need for affordable homes, and it hoped to create many hundreds of new low cost homes each year.

Natcon wanted to build a large estate of new homes in the town of Housteads and the local government authority granted the required building permission. But the nearby University of Housteads strongly opposed it because it believed the new houses would ruin what was considered to be a panoramic view from the university campus which helped it to recruit staff and students to the university. Both the Housteads local government authority and the University of Housteads had money from reserves invested as clients (i.e. fund investors) with R&A, but with the university having a substantially smaller investment in the fund than the local government authority. The local government authority also owned shares in R&A, meaning that it was both an investor in funds and a shareholder in R&A.

Required:

(a) Distinguish between private and institutional shareholders, and discuss the agency problems which might arise when an institutional shareholder such as R&A holds money in funds on behalf of clients (i.e. investors in R&A funds). (7 marks)

(b) Explain the difference between 'corporate social responsibility (CSR) strategy' and 'strategic CSR', and construct the argument that the purchase of Natcon (the house builder) is an example of strategic CSR. (10 marks)

(c) Explain how stakeholder claims are sometimes in conflict and, using a suitable stakeholder analysis framework, assess the competing claims of the local government authority and the University of Housteads in the proposed housing development. (8 marks)

(25 marks)

3 A major corporate governance code contains the following entry on audit committees.

The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's external auditors.

The board should establish an audit committee of at least three, or in the case of smaller companies, two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. All audit committee members should be considered independent upon appointment to the committee. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

When Hafnium Company floated on the stock exchange, it attempted to establish the audit committee required by the listing rules. It was unable to recruit a non-executive director with the requisite financial experience so it appointed experienced non-executive director, Sophie Xu, as the committee chairman. Sophie Xu was a technical engineer. She was appointed to the board of Hafnium because of her expertise in the technology used by Hafnium and she understood the company's business model and its systems. But she did not understand financial matters.

Sophie Xu told colleagues that she did not understand much about the concept of independence. She said that in her own field of engineering, colleagues inside and outside a certain company often supported each other and that this was often encouraged. As a community of specialists, they often found that helping each other was an important part of professional life over the years. Accordingly, she said she did not really understand why independence was important for audit committee members. She also said that she did not understand much about the company's relationship with the external auditors.

Required:

(a) Define 'independence' in the context of audit committees, and explain why audit committee members should be 'considered independent' at the time of their appointment. (8 marks)

(b) Discuss how the inability of Hafnium Company to recruit a person with 'recent and relevant financial experience' might threaten the effectiveness of the audit committee's contribution to shareholder value. (8 marks)

(c) Explain the nature of an 'appropriate relationship with the company's external auditors' and discuss how Hafnium Company's audit committee should respond if it believes the relationship to be too close. (9 marks)

(25 marks)

4 Pulpo is a local pulp and paper factory. As a subsidiary of a major international company, Pulpo has not produced a social and environmental report for itself, but instead provided data which was fed into the parent company's group report. There was some discussion about Pulpo having an environmental report on its own website but no resources were provided for its development, so nothing ever materialised.

Mary Wong was the manager at Pulpo whose responsibility was to monitor and report on environmental emissions. It was her responsibility to monitor emissions and to feed data into the company's internal control systems on resource consumption (energy and water) and waste. It was a job she enjoyed because it enabled her to express her personal concern for the environment in her work. When she took over her role two years ago, she was told that the company had very ambitious voluntary emission targets and that they would eventually be reduced to make the company even more environmentally responsible over time. Mary found this exciting and it was on this basis that she agreed to accept the appointment. Because of the sensitive nature of some of the data she managed, her employment terms and conditions included a confidentiality clause in which she agreed never to publicly disclose the environmental targets or the company's performance against them.

When investment in new manufacturing capital was delayed because of a deteriorating profit performance, Mary was informed that the emissions target would be temporarily increased because the ageing equipment would not be able to maintain the low level of emissions. Dismayed by this change, she complained to the company chief executive but was told that she had to accept the higher emissions until the company could afford its factory investment, which could be several years in the future.

She decided that the most effective way to deal with this change was to publicise it to the local newspaper and to the nearby residents' association, both of whom had been longstanding critics of the factory's impacts on the environment. The public reacted angrily to the disclosure as it was already considered a 'dirty' factory which often emitted fumes and effluent, which polluted the local river. When the board of the company discovered her actions, she was dismissed for breach of her terms and conditions in publically disclosing the confidential information.

Required:

(a) Distinguish between Kohlberg's conventional and postconventional ethical responses and explain, with reasons, which ethical approach Mary Wong took in her decision to publicise the change in emissions target. (9 marks)

(b) Construct the case for Pulpo to now publish an environmental report on its own website in addition to that provided by the parent company. (8 marks)

(c) Explain the meaning of 'internal control' and discuss why a sound internal control system is necessary in managing Pulpo's environmental footprint. (8 marks)

(25 marks)

End of Question Paper