Answers

1 (a) Transparency

This is the important quality of governance which specifies that companies should disclose all material information to shareholders and others unless there is a valid and defensible reason to withhold it. It implies a default position of disclosure over the concealment of information.

Given the information provided in the case, Xaxa cannot be fairly criticised for a lack of transparency. There was no attempt to hide the reasons why Xaxa had remained in the baby food business, with the chief executive saying that it was a 'profitable business opportunity' and that he 'owed it to the shareholders to maximise their return'. Likewise, when the Oublie Group put the questions to management, it received direct and seemingly honest replies to each one. There is no evidence from the case which suggests that Xaxa sought to be surreptitious or concealing in its behaviour or dealings with shareholders.

Judgement

Because corporate governance is based on decision-making, the ability to make sound and balanced judgements is an important underlying principle. In many cases, judgement is the ability to decide between two credible courses of action, and making finely-tuned calculations in so doing. The decision-maker's personal attitudes to risk, ethics and the timescale of likely returns are likely to be important factors in how a person judges a given decision.

It is clear from the case that the Xaxa board strongly discounted any ethical consideration in reaching its judgement in remaining in the baby food market in developing countries. By adopting a 'stockholder' or pristine capitalist/expedient view on the importance of profits over and above the ethical and reputational issues, the board of Xaxa demonstrated something about its attitudes to ethics and risk. When the other two companies named in 'Killer Companies' judged that it was safer to withdraw from the market, Xaxa reached the opposite conclusion and this says something significant about the board's judgement. Some will conclude, as MWC and the Oublie Group did, that the Xaxa board has demonstrated poor judgement and blatant opportunism on this issue.

Reputation

It is important that companies are seen by stakeholders as competent, ethical, fair to others and reputable. Company boards must enjoy the full confidence of several important stakeholders in order to enjoy full access to resource and product markets. A poor reputation can quickly affect a company's ability to, for example, attract high quality employees, sell its products or attract capital.

The fact that, of the three companies criticised in 'Killer Companies', two withdrew straightaway, suggests that there were strong reputational issues to be considered. MWC is actively seeking to challenge Xaxa's reputation as an ethical company with its slogan ('Xaxa kills babies') and its calls for a boycott of other Xaxa products, supported by the information in the television programme. Similarly, the board's effective dismissal of the concerns of the Oublie Group suggests that the Xaxa board may struggle to maintain the full confidence of some shareholders, especially those 50 institutional shareholders in the Oublie Group. It looks likely that Xaxa's reputation will have been damaged by the events over the baby food debate, and the board should perhaps consider measures which would partly restore its reputation if it wants to avoid longer term damage to its name. Legal risk could negatively affect the reputation of Xaxa if it were sued because of insufficient or inadequate preparation instructions on the product.

(b) Purposes of a corporate code of ethics

There are five broad purposes which a corporate (as distinguished from a professional) code of ethics can achieve. The first is to *establish the organisation's core values* and to stimulate internal discussions about these values. These form part of the organisation's underlying environment (infrastructure) and help to promote behaviour in support of the organisation's mission. The second is to *recognise and promote stakeholder responsibilities*. This may include identification of the important stakeholders, which stakeholders to privilege over others and the postures to adopt towards those stakeholders.

Third, corporate codes of ethics are designed to *control behaviour and guide decision-making*. When drafted as a *de facto* policy document, employees and management can use the code to guide them whenever a given ethical situation arises. It can ensure a uniformity of approach to ethical issues and help to prevent unethical behaviour. Fourth, the code can be an important element in the organisation's *strategic positioning*. Ethical reputation can be as important a component of a company's strategic positioning as much as its power over suppliers or buyers, or its ability to increase the switching costs of competitor products. Finally, as a public document, the code can help to *convey values and ethical standards* to stakeholders. This could mean, for example, that shareholders could scrutinise the code to see if the company's values accorded with their own. Alternatively, current or potential employees could use it to see if the company is one they would like to work for.

Xaxa Company reconsidering its participation in baby food markets

The first way in which having a code of ethics might cause Xaxa to reconsider its strategy is in *considering the stakeholders affected by its operations*. If the evidence offered by 'Killer Companies' and the television programme is accurate, then a stakeholder analysis would highlight the negative effects that its baby food marketing was having. In the reply to the Oublie Group, the board remarked that it was unprepared to consider 'other claims made against the company strategy' but were such an analysis to be conducted, the company would be fully aware of the effects of its business in the poorer countries. Also, as an 'inward-looking' company (according to Hugh Oublie's belief), the Xaxa board may not be fully aware of the effects of its business in those countries.

Second, it would have the potential for Xaxa to *consider its strategic positioning* in respect to ethical issues. Given the reaction by MWC and other groups, the ethical reputation of Xaxa has probably deteriorated and a review of this would have the potential to improve its ethical positioning. Withdrawal from the baby food market in developing countries would remove the threat of MWC protests and of consumer boycotts of its other products.

Linked to this, the code would allow Xaxa to clearly demonstrate its commitment to certain ethical standards. This would enable external stakeholders to *hold Xaxa to account*, by comparing actual behaviour against disclosed intent, and help to challenge poor ethical behaviour. It would be very difficult, for example, to convey an ethical aspiration that shareholder value should be pursued regardless of other stakeholder impacts, and so some change in behaviour may be necessary to help with this.

[**Tutorial note:** *Allow discretion in answering this, as several additional points are valid.*]

(c) (i) **Investor intervention**

It is considered to be a serious matter when investors seek to intervene directly in the running of a company. This is because intervention, by definition, represents a partial failure of the agency relationship in which directors are entrusted, by shareholders, to run a company responsibly on their behalf.

There are several situations in which investors might attempt to intervene directly, either by challenging management at a general meeting or by writing directly to the chairman to challenge his or her position. *Concerns about company strategy* are the most common and perhaps most serious reasons for intervention. If the board is pursuing a strategic course of action which is not in keeping with the wishes of the shareholders, either in terms of its ability to make adequate returns or because of its risky or unethical nature, shareholders may object directly to the company. Second, a sustained period of *poor operational performance* or inadequate levels of return, given the amount of risk incurred, could bring about direct intervention.

Third, *weak non-executive directors* (NEDs), unable or unwilling to scrutinise the executive board, may be a reason for intervention. The NEDs are appointed specifically to represent the interests of shareholders and therefore they must be able to discharge their role effectively. Fourth, any particular or serious *internal control failures* which would restrict value adding or add significant waste to organisational systems. A failure to be able to operate safely and efficiently is a serious management failure and could cause some shareholders to seek to intervene in the company.

Fifth, any unexplained or sustained *compliance failure* can be serious enough to merit intervention. This could be a failure to comply with legal statutes, to comply with accounting standards, to meet filing deadlines, to keep tax affairs in order, etc. Finally, there may be *concerns over governance and ethics* at the company. Issues such as excessive remuneration or poor ethical performance would fall into this category.

(ii) **Intervention at Xaxa**

At Xaxa, the case highlights two prominent reasons for intervention. First, there is evidence of *weak non-executive scrutiny*, certainly in the opinion of longstanding shareholder Hugh Oublie. Given that the non-executive component of the board is ineffective when it comes to strategic scrutiny, Hugh Oublie believes that the executive board is not being adequately held to account by the NEDs. A board which is 'inward-looking' is unlikely to have an effective NED presence, for example. In addition, however, the risk advisory role of NEDs may help to ensure that the board considers the risks involved in its baby food marketing, especially its reputation risks and the risks to its resource and product markets. Given that they feel there is no effective NED representation on the board, the Oublie Group believes itself within its rights to confront the board about this issue.

The second reason for shareholder intervention at Xaxa is concerns about governance and its *poor attitudes towards ethics*. The company's disregard for the consequences of its baby food sales in poorer countries suggests a questionable ethical stance, and this is certainly the case in the view of the Oublie Group of shareholders and other influential stakeholders such as MWC. Not only is poor ethical behaviour a potential source of reputation and other risks (such as customers boycotting Xaxa products), it may also contribute to an unfortunate repositioning of the company as a 'bad' company. Such a reputation is unlikely to be what prominent shareholders seek from their investment and if management is intransigent, the case for direct intervention by the Oublie Group may be strong.

The third reason for intervention is the concern, expressed by Hugh Oublie, over the *strategy and strategic management at Xaxa*. Although profitable, it is likely that the Xaxa board is paying insufficient attention to the medium-term business risks which could arise as a result of the baby food controversy. The belief of the board that concern over the baby food marketing was a temporary concern might demonstrate a short-sightedness and a lack of insight on the nature of business risk. Boards of directors, as stewards of shareholder value, must always be aware of the potential effects of controversial business decisions on reputation and other factors which can give rise to business risks.

(d) (i) Thank you for commissioning this consultancy to advise Xaxa on risk auditing and related issues. In the first instance, we have drafted notes to assist in the stages of the risk audit. We have carried out a preliminary analysis of the company to serve as a basis for discussion and hope this will help in the board in being able to see the benefits of this service.

Risk audit is an important component of sound corporate governance and highlights the risks affecting a company and the measures taken to mitigate those risks. In most jurisdictions, there is no specific direction as to who should carry out this role and both internal and external auditors can be employed. We will return to the issue of internal and external audits later in these notes. We now turn to the stages in a risk audit.

The first stage in a risk audit is *risk identification*. It is especially important that all relevant risks are identified because it is only when risks are identified that subsequent stages of the audit can be conducted. The maintenance of a risk register is one way in which companies achieve this, with new risks being added and obsolete ones being deleted if they no longer apply. In the case of Xaxa, there are several obvious risks which will apply because of its size and the complexity of its business. Operating in many different countries will incur exchange rate risks, for example, and the issues which have arisen over the marketing of baby food may give rise to political risks, reputation risks, product market risks and resource market risks, if, for example, the company has difficulty in recruitment.

Once identified, each risk must then be *assessed*. This requires estimating the probability of each risk materialising and the impact of such a risk realisation. For some risks, these might be relatively straightforward to calculate but for others, more subjective estimates must be made. We have noted, for example, that the effect of the publicity generated by 'Mothers Who Care' may have not only increased the risk of a consumer boycott but may have made the impact worse by the use of inflammatory and provocative slogans such as 'Xaxa kills babies.' Accurate risk assessments then enable the company to see which risks should receive the most management attention.

The *review of controls* is the third stage of the audit. Once a risk has been identified and assessed, this stage considers the effectiveness with which it is controlled or mitigated. Those risks with higher probabilities or higher impacts may, for example, require more effective mitigation strategies than those assessed as less so. If a control is found to be inadequate, this stage of the risk audit will highlight the need for strengthening the control. If a control is currently more than is necessary (perhaps costing a disproportionate amount given the probability or the impact), it can be reduced.

The final stage is to issue a *report* to management for future planning and decision-making. This report will highlight the key risks, those requiring the most immediate and urgent attention, and a comment on the quality of existing assessment procedures. Any assessment shortcomings or resource constraints will be clarified and barriers to subsequent risk audits highlighted. Although at a very early stage, it may be the case, for example, that the board of Xaxa has underestimated the risks associated with its decision to continue and expand its baby food business in poorer countries and this report would be able to show that.

(ii) Distinguish between

Internal risk audit is one undertaken by employees of the company being audited and is usually carried out by the internal audit function. Externally, consultants provide this service to clients. In some cases, this is a non-audit service offered by accounting practices and other consultancies specialise more specifically on risk including the provision of risk audit services.

Advantages of external risk audit

In the case of Xaxa, we believe an internal risk audit would be a less effective option than a full risk audit by an external party. There are several reasons for this.

First, an external risk audit will *avoid familiarity threats* by the auditor. The company's internal auditors are likely to be working within the company's culture and perhaps 'contaminated' or at least 'affected' by it. In the case of Xaxa, this may be less helpful because of the need, as the board has realised, of gaining an outsider's view of the company and its issues. It is not our place to question Xaxa's culture but we have noted with interest, comments made in the media suggesting the company is 'self-reliant' when perhaps some external scrutiny would be beneficial.

Second, an external risk audit will be neutral and *independent in its approach*. Those with experience in the company may feel themselves to have a greater familiarity with its risks and risk control systems but may, in adopting such an attitude, have overlooked or underestimated some risks. A 'fresh pair of eyes' will not bring any previous 'baggage' and will bring about a more thorough and impartial outcome.

Third, an external risk audit, assuming it is accompanied by a report to shareholders, will *enhance investor confidence* in the process and in Xaxa's risk management. This may be especially important when a company has been faced with a situation which has caused tension between a board and the shareholders such as at Xaxa. It seems evident that the Oublie Group has a number of issues with regard to the company's risk management and an external risk audit will help to cultivate the important relationship between the board and its institutional investors.

Finally, we believe that current thinking and *best practice can be more effectively transferred* when the audit is undertaken by external parties. External auditors often see practice in many companies in the course of their work and by selecting the most effective practices and sharing that knowledge with subsequent clients, best practice is shared and propagated. Risk audit by internal people is less likely to be aware of latest thinking because of their lack of exposure to other companies and their approaches.

2 (a) Risk appetite

This describes the general posture an entity (in this case, Bob, an individual investor) has towards risk. It describes the investor's position on a continuum between risk aversion and risk seeking. A person with a high risk appetite will be risk seeking and a person with a low risk appetite will be generally risk averse. It is broadly assumed that higher risk is associated with greater gains and losses, whilst greater returns will, over time, be gained with higher risk investments. Lower risk investments are generally assumed, over time, to attract lower returns.

Risk awareness

In the context of Bob's investments, risk awareness describes the ability of an investor to recognise and measure the risk associated with a given investment. Some investments (i.e. the shares in a company, government bonds, company bonds and debentures, etc) have structurally higher risk than others by virtue of what they are and where they lie in the priority of claims in the event of liquidation. For investors seeking to balance a portfolio of investments in line with their personal risk appetite, it is essential to be able to know the general level of risk attached to each one.

Choice of investments

If Bob is generally risk averse, he will seek out investments which have *low levels of uncertainty and predictable levels of return*. The 'price' of this certainty is usually a *lower return over time* than a more risky investment, but as part of a portfolio, lower risk investments provide a base upon which it is possible to build with selected higher risk shares. Typical lower-risk investments are company bonds (long-term loans to a company at an agreed rate of interest) or, presumed to be even lower risk, government bonds. These are issued when a country's national debt is financed by individual loans at an agreed annual rate over a fixed number of years.

If Bob is generally risk seeking, it is likely he wants greater returns and is prepared to bear a higher risk in order to achieve them. He will accordingly seek out investments which have *greater levels of uncertainty and more volatile levels of return*. These are likely to be shares in companies in complex or more turbulent environments, possibly less diversified, and with a *possibility of substantial loss as well as capital growth*. Larger companies with diversified interests and a relatively predictable long-term level of return are less likely to be a key part of a risk-seeker's investment. He or she is more likely to opt for smaller companies, those in emerging markets or those in growth sectors which could make a substantial long-term return compared to more established alternatives. Beta factors are one way of measuring and assessing the relative financial risks or volatility faced by an individual company in a market as a whole. Risk seeking investors may invest in companies with a beta greater than one.

(b) Business risks

These are risks which can threaten the survival of the business as a whole and they can arise from many sources. Essentially though, they arise because of the business model which an organisation operates and the strategies it pursues. Some business activities, by their nature, give rise to certain risks which can threaten the business as a whole. Some business risks can affect the 'going concern' status and threaten the survival of the business. This is when the continuation of a business in its present form is uncertain because of external threats to the business at a strategic level, or a failure of the business's strategy.

Financial risks

These are the risks which arise from the way a business is financially structured, its management of working capital and its management of short and long-term debt financing. Cash flow can be strongly influenced by how much debt to equity a business has, its need to service that debt and the rate at which it is borrowed. Likewise, the ability of a business to operate on a day-to-day basis depends upon how it manages its working capital and its ability to control payables, receivables, cash and inventories. Any change which makes its cash flow situation worse, such as poor collection of receivables, excessive borrowing, increased borrowing rates, etc, could represent an increased financial risk for the business.

How risks vary by sector

The website was correct when it said that risks vary by business sector. A bank, for example, might be especially vulnerable to financial and capital adequacy risk whereas a mining company might be especially vulnerable to health and safety risk. This is because of the different environments, and the business models, strategies and financial structures adopted by companies in different industries.

Sectors exist in *different environments*. This means that the external factors which affect businesses and give rise to risks are different. Some industries, for example, are mainly located within a certain geographical area whilst others are international, thereby giving rise to such risks as exchange rate risk, etc. Some exist in relatively simple and stable environments whilst others are in more turbulent and changeable environments. Thus, in more unstable and complex environments, perhaps with greater levels of regulation, changing consumer patterns and higher technology, companies will be subject to greater risks than those in more stable and simple environments.

Companies in different sectors *adopt different business models*. This means that the ways in which value is added will differ substantially among companies in different sectors. In a service industry, for example, value is added by the provision of intangible products, often with the direct intervention of a person. In a manufacturing company, there will be risks associated with inventory management which a service industry will not be exposed to. Conversely, a company in a service industry such as insurance or banking is more likely to be exposed to certain technical skill shortages and fraud risks.

Different sectors have *different financial structures, strategies and cost bases*. Some companies, by virtue of their main activity, rely heavily on short or long-term loan capital whereas others have lower structural gearing. Others have even more complex financial structures. These financial structures give rise to different costs of capital and differential vulnerabilities to such external factors as monetary pressure. So whereas a traditional manufacturing company might have very little debt, a civil engineering business undertaking individual large projects might take on large amounts of medium-term debt to finance the project. This means that risks are greater in such a business because of the financial gearing which is lower in the traditional company funded mainly by shareholders' equity or retained surpluses. Banks rely on a range of funding sources and become vulnerable to losses when these become difficult or the price of gaining these funds rises for any reason. Some companies have different cost structures which make them more risky in different economic circumstances. Companies with high operational gearing, such as those having very high fixed costs compared to variable costs, have more volatile returns simply because of the structure of their cost base.

(c) Mandatory and voluntary disclosures

Annual reports contain both mandatory and voluntary components. Mandatory disclosures are those which are required, either by statute (e.g. company law), reporting standard or listing rule. The main financial statements, with their related disclosure notes, and the audit report fall into this category. These are the statement of profit or loss, the statement of financial position (balance sheet), the statement of changes in equity and the statement of cash flows. Some parts of the directors' report are also mandatory in some jurisdictions as are notes on the composition of the board and the remuneration of directors. Listing rules in some jurisdictions have increased with regard to disclosure requirements. In many countries, for example, a substantial amount of corporate governance disclosure is required, as is the 'comply or explain' statement. The presence of the 'comply or explain' statement is often mandatory but the content is used to convey the extent of non-compliance with the relevant corporate governance code.

Voluntary disclosures are those not required by any regulatory constraint but are often made nevertheless. Some of these are made because of tradition and shareholder expectation (such as the chairman's statement) whilst others are thought to be concerned with managing the claims of a company's wider stakeholders. Some companies include disclosure on objectives so that shareholders can understand the board's ideas for the future, possibly including a mission statement or similar. Likewise, social and environmental information is often included, detailing, for example, the company's policy and objectives with regard to a range of social and environmental measures. Some risk disclosures are also voluntarily supplied, for example, when a company is adopting an integrated reporting approach.

Usefulness of CG disclosure

Corporate governance disclosure in the annual report of a listed company is often required by listing rules although the content of what is required varies by jurisdiction. In most cases, however, corporate governance disclosure includes information on the directors (both executive and non-executive), information on strategy, reports from board committees (including the remuneration committee), risk reporting and information on any unusual or extraordinary events.

The information *about the board* will enable Bob to see the balance of the board of directors which leads the company and also those non-executive directors who help and support the executive board. By studying the experience of the directors, he can eventually take a view on how well the board is likely to lead the company. If the board is in any way non-compliant with relevant laws or listing rules (say on the balance between executive and non-executive directors), this may tell him something about how well other parts of the company are likely to be run.

Risk reporting will enable Bob to gain an understanding of the number of risks which the company feels it faces and the policies the company has in place for managing those risks. Because the specific risks faced by companies vary so much by sector and by company, these disclosures can enable Bob to understand the types of issues which may emerge to threaten the value of his shares in the company. Risk reports are necessarily speculative and incomplete, however, and other risks can materialise which were not predicted by the company. Comparing risk reports year on year and comparing those of companies in the same sector could also prove helpful.

Board committee reports will enable Bob to learn about the role of non-executive directors in the company and how they counterbalance, support and constrain the executive board. In many jurisdictions, the corporate governance report includes a report by the remuneration committee, for example. This enables the non-executives comprising the committee to inform shareholders (or potential shareholders such as Bob) about the policies they adopt in rewarding executives, and to report on historical detail of what the executive board was paid in the financial year just ended. Bob can form a view of whether he believes the policies look consistent with the company's strategy and whether the directors are fairly paid (or overpaid) for their performance.

The *compliance statement*, often referred to as the 'comply or explain' statement in a principles-based jurisdiction, will tell Bob the extent to which the company is compliant with the provisions of the relevant code of corporate governance. If it is not compliant, this statement will inform him of the seriousness of any breaches and he can also judge the explanation given, as to why the company is not in full compliance. If there is a serious breach and a weak or unconvincing explanation is given, Bob may well take that into account when considering making an investment in that company's shares.

[**Tutorial note:** *Exercise discretion in marking the section on the usefulness of CG disclosure as there are a number of other valid answers which can be used.*]

3 (a) Ethical threat

The term 'ethical threat' is used in some professional codes of ethics to describe any factor which may reduce the effectiveness of a professional person and his/her ability to act in the public interest, free from any countervailing concern which might threaten his or her independence.

In the ACCA and IESBA (IFAC) codes of ethics, there are five general ethical threats identified: self-interest, self-review, advocacy, familiarity and intimidation. Each of these can make it difficult for the professional to act without coercion or undue influence. The term is often used in the context of auditing (internal or external). It is important that auditors are free of any ethical threats in conducting an audit so as to ensure that the audit is performed thoroughly and solely in the interests of the shareholders.

Ethical safeguard

An ethical safeguard is a constraint or control placed upon a professional person or an organisation to prevent the occurrence of any of the ethical threats mentioned above. Safeguards are imposed from two sources: those created by the profession, legislation or regulation, and those created from within a given firm's own systems and procedures. The external regulation of audit includes several provisions intended to ensure the independence of an external auditor, whilst some organisations also have their own rules for ensuring that employees or contractors are not compromised in their ability to act independently and without acceding to any vested interests.

Benefits of ethical safeguards

The primary benefit of any ethical safeguard is *to protect an individual or an organisation* from the effects of an ethical threat. The provision of both audit and non-audit services by Hum and Hoo raises several potential ethical threats, particularly to independence. By instituting effective safeguards, these hazards can be avoided. It is important that, as a professional organisation, the *appearance of ethical threats is avoided as well as the actual avoidance itself*. The fact that staff can work on both audit and non-audit work and that the lines between the two are blurred, represents a challenge to the imposition of effective safeguards at Hum and Hoo.

In addition, however, the presence of effective ethical safeguards *underpins public trust and the confidence of shareholders*. The reputation of accountants in society is a crucial component in their professionalism. Ethical threats, unchecked by effective ethical safeguards, undermine the professional reputation and introduce unhelpful factors which make it difficult for accountants to operate normally. Professionals such as auditors, and accountants performing non-audit services, are only helpful to shareholders (in the case of external audit) or service clients (in the case of non-audit services) precisely because their independence cannot be questioned.

A third benefit of ethical safeguards is that they *enable the effective delivery of both audit and non-audit services* without the frustrating factors (ethical threats) which might render some services ineffective. So the fact that an ethical safeguard is in place means that a professional can conduct business knowing that his or her independence will not be questioned. An external auditor, for example, must have the full confidence of shareholders, and safeguards limiting interactions between them and their clients mean that they can be, and be seen to be, independent of them.

(b) Explain environmental audit

One of the initiatives which companies have used to convey their environmental policies and performance is the environmental report. These are usually 'stand alone' or web-based media containing content on policy, performance against targets on resource consumption (including water, energy, etc) and emissions, including carbon, other chemicals, pollutants and waste.

As with any other audit, the purpose of an environmental audit is to assure that the information given is a true and fair view of reality. This means that if a company makes a disclosure about a given measure, it is essentially accurate.

Demonstrating environmental sustainability

Cherry Hoo correctly identified one of the issues with environmental reporting: it is voluntary in most jurisdictions and not subject to any agreed accounting standard. This means that the ability of a company to 'demonstrate its environmental sustainability' *depends upon what, and how much, is measured and disclosed*.

If the company *measures all of its environmental impacts*, including those inputs which cannot be replaced by recycling, it is likely to be able to produce a more detailed and meaningful environmental account. This would involve stating how much material has been used, how much of it can be replaced or re-used, what the precise environmental outputs are and the extent to which these can be offset or not. This would then be able to be audited and a true and fair view arrived at.

If the company were to elect to disclose less, perhaps in what some commentators have referred to as a 'greenwashing' exercise, then it is *likely that the environmental report will only weakly describe the organisation's sustainability*. If the report contained content which was not measurable (perhaps aspirations rather than measureable content), then the audit would be much more difficult to perform (because there is less to assure).

In conclusion, an environmental report will enable a company to 'demonstrate its environmental sustainability' if the correct metrics for sustainability are measured and reported on and if the auditors are able to assure, by way of available data and agreed ways of measurement, those metrics. A weaker form of sustainability would be measured by a less detailed form of environmental reporting and audit.

(c) Public interest

The public interest is one of the key themes in professionalism, including in accountancy. To act in the public interest means to act for the benefit of the *collective wellbeing of society* as a whole. This means that accountants should serve the interest of *clients, shareholders, governments and other stakeholders*. In accounting services, accountants need to be aware that when conducting an audit, they need to be impartial and unbiased because they are acting in the interests of shareholders. Society relies upon the premise that accounting reports are true and fair, and useful for decision-making. Anything which might erode that premise is *against the interests of stability in society* and therefore against the public interest.

Approval by the audit committee

Some codes of corporate governance, such as Sarbanes Oxley, specify that some non-audit services can be provided by the external audit firm but only with the express consent of the client's audit committee. Other codes and regulatory instruments also have provisions for the assessment of whether non-audit engagement is valid and acceptable.

The audit committee is well-placed to rule on the purchase of non-audit services for the following reasons:

First, a key part of its purpose and brief is to *take responsibility for the independence of the external audit*. The audit committee has the authority to recommend a change in external auditor if it believes that it is not capable of delivering an unbiased or independent audit. Because it is concerned with auditor independence and has this power to recommend a change in auditor, it is usually able to judge whether non-audit services provided by auditors are affecting auditor independence. The presence of an effective audit committee is also a check and balance against management attempting to capture an external auditor (i.e. they will not seek to capture an auditor because they know they are being monitored by the audit committee).

Second, assuming the company is compliant with its relevant corporate governance code, the audit committee will be made up mainly of *non-executive directors* (NEDs) *with no vested financial interest in the company*. In most jurisdictions, NEDs are prevented from holding shares or share options in companies they are NEDs for. This is to ensure their impartiality and remove any temptation to gain short-term bonuses or to be concerned with short-term issues. Whereas some executives may have a financial incentive to behave in a way which will provide, say, a favourable variance against a budget which underpins their personal bonus, NEDs have no such issues. This facilitates an impartiality which is essential in NEDs being able to identify ethical threats and therefore prevent the activity which causes them.

Third, it is the purpose of the audit committee to *represent the interests of shareholders* against any potential vested interests of executive directors and other company senior management. It is very much in the interests of shareholders to ensure the independence of an external auditor, and an audit committee would be highly dysfunctional were it to permit any behaviour counter to the shareholders' interests. NEDs are an important part of a corporate governance system because they explicitly represent shareholders, sometimes against the interests of executives. In this capacity, they are able to bring scrutiny on shareholders' behalf.

It should be noted that the audit firm themselves is additionally required by the ACCA *Code of Conduct and Ethics* to determine whether providing such services would create a threat to independence. Furthermore, if the client is defined as a 'public interest entity' such work is not permitted at all by the Code.

4 (a) Conventional ethical behaviour

Kohlberg's three stages of ethical development are the pre-conventional, the conventional and the post-conventional. Each of these has its own likely ethical response.

The conventional ethical response is to believe that *the ethical right is to comply in full* with whatever regulations apply or whatever orders are given in the context they are operating in. It assumes that the highest ethical position is to be in compliance with whatever rules, regulations or requirements are applicable at the time. So the individual's focus is on positioning themselves *so as to maximise his or her ability to comply*. This might involve learning how to adopt compliant behaviour, learning about compliance requirements and familiarisation with the cultural norms which apply.

For Mahmood, it is clear in the case that he has been ordered by his manager to 'say nothing' and to 'conduct his job as normal'. A conventional ethical position would not reflect beyond this. His instructions are clear and *he would see virtue in obedience* to this instruction. The fact that he is a part of an organisational hierarchy and that those in a supervisory position over him have imposed a rule for him to comply with, is sufficient for him.

Post-conventional ethical behaviour

To adopt a post-conventional ethical response is to see a 'higher' ethical duty despite whatever laws, regulations, norms or instructions apply at any given time. What Kohlberg referred to as 'universal principles' are essentially subjective, meaning that each person can have his or her view of what those are. But in each case, a post-conventional actor will consider the ethical 'right' not in line with current regulations (which can change over time) but with his or her higher principles, perhaps those concerning concepts such as justice, fairness, compassion, decency, etc.

For Mahmood, post-conventional behaviour might involve him *questioning the morality of the decision* to include inferior meat in the company's products in the interests of what he sees as the 'greater good'. He may come to the view, for example, that honesty and truthfulness to customers is a higher or 'universal' principle, *even though the board of Tzo Company appears to have decided to introduce the inferior meat into its premium meat product*. In such a situation, he could maintain, but suppress, his beliefs for the sake of keeping his job, or he could act upon his belief. Because he has had no satisfaction from his manager at Tzo, *he might believe it ethically right to inform an external source, such as a newspaper*, as he is considering. Post-conventional behaviour is often costly to the actor and if Mahmood were to become a whistleblower in this case, he may well lose his own job and cause others to lose theirs.

(b) Ethical case

In recognising that it would be very costly on a personal level for Mahmood to act as a whistleblower in this case, there is a strong ethical argument that he should do so.

The company is acting in a *concerted manner to deceive customers* by selling food which is not what they believe it to be. As an employee of the company, Mahmood is taking part in a value adding process which results in a product which is not what the customer thinks they are purchasing. It may be that the inferior meat, even if safe to eat for the majority, is unsuitable for some diets or which may offend some consumers' personal or cultural beliefs. In a trades-description sense, this deceit is a breach of customers' trust. It may cause offence to some and possibly even illness in others if they purchased a product unaware of the inferior nature of the contents.

Because the *board of Tzo Company is complicit* in the decision, he is unlikely to get any change of mind from anyone in the company. So the only way to highlight the deceit is to go outside the company. Were he to adopt the normal grievance procedure by observing the chain of command in the company, the involvement of the board of Tzo Company in the use of inferior meat would make it unlikely he would get a sympathetic hearing. In fact by raising the issue internally, he might risk his own safety or the comfort of his position at work. So going to a newspaper may be the only way he can reasonably expect to see the problem addressed.

The division is *falsifying quality control reports* and therefore intentionally misleading whoever it is who receives these – perhaps a food standards agency, a regulator or similar. This control is presumably intended to ensure that the company's main output is of a high quality as stated, and that the quality assurance measures are met for the product. The falsification of the report means that normal quality procedures are being systematically subverted and this is a very serious matter. Again, the fact that the board of directors has sanctioned this makes it unlikely that Mahmood would receive a sympathetic hearing, thus making the case for going directly to the newspaper.

It is in the *public interest* to highlight a situation in which a company is mislabelling food, deceiving customers and shareholders, and requiring its employees to take part in the deceit and remain quiet about it. This is not how business should behave and it could serve to erode society's trust in business in general. Employees have an ethical right to work for a company which is not structurally deceitful and were such a situation to persist, it could undermine management–employee relations and open the company up to legal and reputational damage. Inasmuch as such a situation is probably likely to be disclosed eventually, a quicker rather than protracted conclusion is preferable.

(c) IC report and preventing the fraud

External reports on the effectiveness of internal controls are intended to convey the robustness of a company's internal controls to an external audience (usually the shareholders). As with other reports, however, the company must make preparations and institute systems to gather the information to report on. This in itself is capable of controlling behaviour and constraining the professional and ethical behaviour of management.

With any report required by regulation, the board must take control of the process and *acknowledge its responsibility* for the company's system of, in this case, internal controls. This means that it would be unable to knowingly circumvent or undermine the internal controls put in place to control the quality of meat in the factory. The regulatory nature of this requirement would also make it an offence to make a false disclosure, meaning that the directors could be held personally liable for any untruths in the report. So although the use of the inferior meat itself may not be illegal as indicated by the factory manager, making an untrue statement on an internal control report over the use of that meat would be an offence.

Any reporting (including one on internal controls) *creates greater accountability* because stakeholders can hold to account those making those statements. In this case, any stakeholder can then point to what was said in the report and hold the board to account for its performance against any given statement. This includes employees such as Mahmood and consumers concerned with product quality. So if Tzo explained the internal controls behind the production of its 'high quality' meat products, it could then be held accountable for any breach in the controls underpinning that quality.

The need to report on internal controls would make it almost impossible *to use the inferior meat without disclosing the fact of its use*, because the penalty for intentionally including misleading or false statements in the report would be high (regardless of whether Tzo is based in a rules or a principles-based jurisdiction). It might then be faced with the choice of continuing to use the meat and admitting it, or discontinuing its use in order to report on internal controls supporting the claimed high quality of its products. Either way, continuing to use inferior meat in a *concealed* way would be very difficult.

A report on the effectiveness of internal controls (such as Sarbanes Oxley s.404) typically requires the inclusion of *a statement on the processes used* by the directors to assess the effectiveness of internal controls. This includes the *disclosure of any material internal control weaknesses* or any significant problems which the company encountered in its internal controls over the period under review. The value of the report as a means of reassuring investors is to use this statement to demonstrate the robustness of the processes. An unconvincing disclosure on this would potentially undermine investor confidence.

Because the report is subject to an auditor's review (or full audit in some jurisdictions), *the auditors can demand evidence of any statement* on the report and follow any claim made back along the relevant audit trail. It is a serious and often easily detectable offence to deceive an auditor or to make a knowingly false statement in an audited or auditor-reviewed report. Such a deceit (of the auditors) would result in an immediate loss of confidence in management on the part of the auditors and, in consequence, also on the part of shareholders and regulators.

1 (a) 1 mark for each explanation.
2 marks for each assessment of Xaxa's performance

(9 marks)

(b) 1 mark for each point of explanation to a maximum of 5 marks.
2 marks for each point on Xaxa reconsidering its position to a maximum of 6 marks.

(11 marks)

(c) (i) 1 mark for each reason for intervention to a maximum of 6 marks.

(ii) 2 marks for each relevant point on Xaxa to a maximum of 6 marks.

(Maximum 10 marks)

(d) (i) 2 marks for each stage explained and discussed in context. Half mark for recognition only.

(8 marks)

(ii) 1 mark for distinguishing between internal and external audit.
2 marks for each advantage of external risk audit to a maximum of 8 marks. 1 mark for identification only.

(Maximum 8 marks)

Professional marks for clarity, logical flow, style and persuasiveness.

(4 marks)

2 (a) 2 marks for explanation of risk appetite.
2 marks for explanation of risk awareness.
1 mark for each relevant point on Bob's choice to a maximum of 4 marks.

(8 marks)

(b) 2 marks for explanation of business risk.
2 marks for explanation of financial risk.
2 marks for each relevant point on risks varying by sectors.

(Maximum 8 marks)

(c) 2 marks for distinguishing between mandatory and voluntary.
Half mark for each example given to a maximum of 2 marks in total for the question.
2 marks for each relevant assessment to a maximum of 6 marks.

(9 marks)

3 (a) 2 marks for explanation of ethical threat
2 marks for explanation of ethical safeguard
2 marks for each importance factor identified and discussed to a maximum of 6 marks. Half mark for identification only.

(Maximum 8 marks)

(b) 2 marks for explanation of environmental audit.
2 marks for each point of assessment of environmental reporting to a maximum of 4 marks.
2 marks for each point of assessment of environmental audit to a maximum of 4 marks.

(Maximum 8 marks)

(c) 3 marks for explanation of public interest in the context of professional services.
2 marks for each relevant point on audit committee to a maximum of 6 marks.

(9 marks)

4 (a) 2 marks for each explanation of Kohlberg's levels.
2 marks for each explanation of how Mahmood would act.

(8 marks)

(b) 2 marks for each relevant argument.

(8 marks)

(c) 2 marks for each relevant argument.

(Maximum 9 marks)