Professional Level – Essentials Module

Governance, Risk and Ethics (Singapore)

Wednesday 11 June 2014

Paper P1 (SGP)

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.

ACCA

The Association of Chartered Certified Accountants

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

1 Several years ago, World Justice, a well-known charity, published a report on the activities of three major food companies in their marketing of manufactured baby foods in some of the poorer developing countries. The report, provocatively called 'Killer Companies', said it had evidence that the three companies were 'aggressively mis-selling' manufactured baby food products in these poorer countries. It was argued in the report that several problems arose with the use of these products in poorer countries which negatively affected the health of the babies, with many babies reportedly dying as a result. These problems included the use of contaminated water in the preparation of the baby food, an inability of parents to read the instructions, making up product at insufficient concentrations (thereby malnourishing the child) and aggressive selling to health facilities in those countries. Doctors often advised against the use of these products for babies because natural feeding solutions were considered safer and more beneficial in most cases.

When the 'Killer Companies' report was published, it was widely reported upon and received a lot of social and political attention. Two of the three companies named in 'Killer Companies' immediately decided to withdraw from the business but the third company, Xaxa Company (Xaxa hereafter), recognised what it believed to be an opportunity to take the market share left by the other two. It set about increasing its production capacity accordingly. When asked by journalists why Xaxa had not also withdrawn from the criticised business activity, the chief executive issued a press statement saying that it was a profitable business opportunity and, as the steward of shareholder value, he owed it to the shareholders to maximise their returns.

When it became widely known that Xaxa had decided to expand and develop its baby food business in poorer developing countries, Mothers Who Care (MWC), a national charity concerned with infant nutrition, organised a campaign against Xaxa. Strongly believing in the natural feeding of infants, MWC initially organised protests outside the Xaxa head office and also encouraged the public to boycott a wide range of Xaxa products in addition to the baby food products. MWC members started to use the phrase, 'Xaxa kills babies' in the hope that it would become widely adopted.

As one of the country's largest companies and operating in many countries, Xaxa has a large issued share volume with the majority being held by institutional investors. Whilst the overall group profits remained strong, some shareholders began to feel concerned about the baby food issue. One prominent fund manager, Hugh Oublie, organised a meeting for institutional shareholders holding large volumes of Xaxa shares and 50 such institutional shareholders attended the meeting. The group became known as the 'Oublie Group'. Although all members of the Oublie Group wanted to retain their holdings in Xaxa because of the otherwise good returns, a number of questions were framed which they decided to put to the Xaxa management:

(i) could the company explain the strategic logic of pursuing the baby food business in poorer developing countries?
(ii) was the board concerned about potential reputational damage with phrases such as 'Xaxa kills babies' being used widely and in the media?
(iii) would the Xaxa board consider withdrawing from the baby food business in poorer developing countries because of the alleged health impacts on children in those countries?

The company issued a statement through its investor relations department, replying that the strategic logic was based on what activities provided the most profit to shareholders regardless of the effects on other claims against the company strategy. Second, the board was not concerned with reputation risks because it believed that these were 'temporary concerns' which would soon be forgotten. Third, no, the board would not withdraw from the baby food market in those countries because, with the loss of two competitors, profit margins were likely to be higher and competition less. The Oublie Group expressed its dissatisfaction with this reply and said it might seek to influence the appointment of non-executive directors (NEDs) to the Xaxa board to increase the scrutiny of the executive members and their discussions on the subject.

Hugh Oublie appeared on television to say that he felt the board of Xaxa lacked balance. He said that, although profitable and a good employer in its home country, the non-executive scrutiny of company strategy had been poor for some time and the board had no meaningful sense of ethics at all. He believed that all of the executive board was dedicated to the mission to produce what he called 'profit at any social cost'. He further believed that none of the non-executive board members was strong enough to question the strategy and raise the problem of baby food as an ethical issue. It was this lack of non-executive scrutiny which Hugh Oublie believed was a major cause of Xaxa's unwillingness to reconsider its baby food activity. He said that he had been a long-serving observer and shareholder of Xaxa and he had noticed the company becoming more inward-looking and self-reliant in recent years. He believed this trend was very unhelpful. In addition, he expressed concerns, on behalf of the Oublie Group, about the strategic management of Xaxa and his belief that the board lacked concern for medium-term business risks brought about by the baby food marketing.

As World Justice and MWC continued their campaigns against Xaxa, some other groups became aware of the baby food situation in poorer developing countries. A television programme reported how Xaxa products were actually being used in some of the poorer countries. It claimed to confirm the problems highlighted in 'Killer Companies' and it highlighted a number of other Xaxa products which consumers might stop buying if they wanted to put pressure on Xaxa's management to change their policy on baby food.

Partly in response to these pressures, the Xaxa board decided to consider two new initiatives. The first of these was to consider introducing a corporate code of ethics. By carefully drafting this and placing it prominently on its website, the board believed that it could achieve a number of favourable outcomes including improving its reputation.

The second initiative was to consider instituting a full risk audit system in response to the negative publicity it had experienced, especially from MWC, whose members were considered to be natural customers of Xaxa's other products. Private research commissioned by Xaxa showed that the baby food business was damaging Xaxa's reputation and possibly the willingness of some talented people to apply for jobs with the company. Political support for other company plans had also suffered, such that a recent planning application to set up a new factory by Xaxa, in a business area with no connection with baby food, had received opposition. Protestors, mainly local activists and MWC members, opposed the application with placards saying 'Xaxa kills babies'. Because the idea of risk auditing was a new initiative for Xaxa, the board has asked a local consultancy to produce guidance on the benefits of risk audit and the benefits of an external, rather than an internal, risk audit.

Required:

(a) The underlying principles of corporate governance include transparency, judgement and reputation.

Explain these three terms and assess the Xaxa board's performance against each one. (9 marks)

(b) Explain the purposes of a corporate code of ethics and examine how the adoption of such a code might make Xaxa reconsider its marketing of baby food in poorer developing countries. (11 marks)

(c) Institutional investors are potentially influential stakeholders in a company such as Xaxa.

Required:

(i) Explain why institutional investors might attempt to intervene in the governance of a company.
(ii) Discuss the reasons why the Oublie Group should attempt to intervene in the governance of Xaxa following the events described in the case.

Note: The total marks will be split equally between each part. (10 marks)

(d) Produce notes from the consulting company for the Xaxa board in response to its need for guidance on risk audit. The notes should address the following:

(i) Discuss, in the context of Xaxa, the stages in a risk audit. (8 marks)

(ii) Distinguish between internal and external risk audit, and discuss the advantages for Xaxa of an external risk audit. (8 marks)

Professional marks will be awarded in part (d) for the clarity, logical flow, style and persuasiveness of the notes. (4 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 Bob Wong was fortunate to inherit some money and decided he wanted to invest for the long term in one or more investments so he would have a higher income in retirement. He was not a specialist in accounting and had little understanding of how investments worked.

Bob studied an investment website which suggested that he needed to be aware of the level of risk in an investment and also that he needed to know what his basic attitude to risk would be. This meant he needed to decide what his risk appetite was and then select investments based on that.

When Bob studied share listings in newspapers, he noticed that they were subdivided into sectors (e.g. banks, pharmaceuticals, mining, retail). He noticed that some sectors seemed to make higher returns than others and he wanted to know why this was. One website suggested that risks also varied by sector and this was partly explained by the different business and financial risks which different sectors are exposed to.

One website said that if a potential investor wanted to know about any given company as a potential investment, the company's most recent annual report was a good place to start. This was because, it said, the annual report contained a lot of voluntary information, in addition to the financial statements. Bob could use this information to gain an understanding of the company's strategy and governance. The website suggested that the contents of the corporate governance section of the annual report would be particularly helpful in helping him decide whether or not to buy shares in a company.

Required:

(a) Explain 'risk appetite' and 'risk awareness', and discuss how Bob's risk appetite might affect his choice of investments. (8 marks)

(b) Explain 'business risk' and 'financial risk' and discuss why risks might vary by sector as the website indicated. (8 marks)

(c) Distinguish, with examples, between mandatory and voluntary disclosure in annual reports, and assess the usefulness of corporate governance disclosure to Bob in selecting his investments. (9 marks)

(25 marks)

3 Hum and Hoo is an established audit practice in Deetown and has a large share of the audit services market among local businesses. Because Deetown is a relatively isolated area, many clients rely on Hum and Hoo for accounting and technical advice over and above the annual audit. This has meant that, over time, Hum and Hoo has also developed expertise in compliance advice, tax, strategy consulting and other professional services.

Because non-audit work is important to Hum and Hoo, staff have 'business growth' criteria strongly linked with bonuses and promotion. This means that many of the professional accountants in the firm actively seek to increase sales of non-audit services to businesses in the Deetown area, including from audit clients. The culture of the firm is such that everybody is expected to help out with any project which needs to be done, and this sometimes means that staff help out on a range of both audit and non-audit tasks. The lines between audit and non-audit services are sometimes blurred and staff may work on either, as workload needs demand. Managing partner Cherry Hoo told staff that the non-audit revenue is now so important to the firm that staff should not do anything to threaten that source of income.

Cherry Hoo said that she was thinking of beginning to offer a number of other services including advice on environmental reporting and the provision of environmental auditing services. She said she had spoken to local companies which were looking to demonstrate their environmental sustainability and she believed that environmental reporting and auditing might be ways to help with this. She said she was confused by the nature of environmental reporting and so was not sure about what should be audited.

Required:

(a) Explain 'ethical threat' and 'ethical safeguard' in the context of external auditing, and discuss the benefits of effective ethical safeguards for Hum and Hoo. (8 marks)

(b) Explain 'environmental audit' and assess how environmental reporting and auditing might enable companies to 'demonstrate their environmental sustainability' as Cherry Hoo suggested. (8 marks)

(c) Some corporate governance codes prohibit audit firms such as Hum and Hoo from providing some non-audit services to audit clients without the prior approval of the client's audit committee. This is because it is sometimes believed to be against the public interest.

Required:

Explain 'public interest' in the context of accounting services and why a client's audit committee is a suitable body to advise on the purchase of non-audit services from Hum and Hoo. (9 marks)

(25 marks)

4 Mahmood is a junior employee of Tzo Company (a large, listed company). Tzo is a processor of food labelled as containing only high quality meat. The company enjoys the trust and confidence of its customers because of its reputation for high quality products. One day, when passing through one area of the plant, Mahmood noticed some inferior meat being mixed with the normal product. He felt this must be unauthorised so he informed his supervisor, the factory manager, who told Mahmood that this was in fact a necessary cost reduction measure because company profits had been declining in recent months. Mahmood later found out that all stages of the production process, from purchasing to final quality control, were adapted in order to make the use of the inferior meat possible.

The factory manager told Mahmood that the inferior meat was safe for humans to eat and its use was not illegal. However, he told Mahmood that if knowledge of the use of this meat was made public, it would mean that customers might stop buying the products. Many jobs could be lost, probably including Mahmood's own. The factory manager ordered Mahmood to say nothing about the inferior meat and to conduct his job as normal. Mahmood later discovered that the main board of Tzo was aware of the use of the inferior meat and supported its use in seeking to reduce costs and maintain profits. In covering up the use of the inferior meat, the factory produced a fraudulent quality control report to show that the product was purely based on high quality meat when the company knew that this was not so.

When Mahmood heard this, he was very angry and considered telling an external source, such as the local newspaper, about what he had seen and about how the company was being dishonest with its customers.

Required:

(a) **Explain how Mahmood might act, in each case, if he were to adopt either conventional or post-conventional ethical assumptions according to Kohlberg's definitions of these terms. Your answer should include an explanation of these two terms.** (8 marks)

(b) **Construct an ethical case for Mahmood to take this matter directly to an external source such as a newspaper.** (8 marks)

(c) Some jurisdictions have a compulsory regulatory requirement for an auditor-reviewed external report on the operation and effectiveness of internal controls (such as s.404 of Sarbanes Oxley).

Required:

Explain how such a requirement may have helped to prevent the undisclosed use of the inferior meat at Tzo Company. (9 marks)

(25 marks)

End of Question Paper