Professional Level – Essentials Module

Governance, Risk and Ethics

September/December 2015

Time allowed
Reading and planning: 15 minutes
Writing: 3 hours

This question 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 question 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.

Paper P1

ACCA

The Association of Chartered Certified Accountants

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

1 Care Services Company (CSC) is a private company, owned by Dr Sam Tan and his wife, Sonja. Sam, a qualified medical doctor, has been involved with the care of elderly and vulnerable adults for over 30 years and set up CSC five years ago to try to improve the quality of care in his locality and to also build a business which he could then sell when he retired. The company employs 180 people in total with 165 of those being the carers who visit service users (usually the elderly, disabled or those with learning difficulties) in their own homes to help with personal needs.

The services provided by CSC are outsourced to them by the local government authority and the government health service. CSC receives funding from these bodies in line with national government policy which determines that care is best delivered by specialist companies such as CSC, rather than directly by the government. Contracts to care providers such as CSC are awarded on a three-year basis. The criteria for provider selection are partly on the basis of cost and partly on the basis of the perception of the quality of the care provided.

Because they deliver important social services and health care, CSC and other companies providing personal care are subject to a rigorous regulatory regime. These regulations apply to all care services, whether provided directly by the government or by companies such as CSC who provide the outsourced care services. All carers, for example, must undergo compulsory training on a wide range of issues. Each potential employee must be checked for past criminal convictions, whilst high standards of hygiene and professional behaviour are expected at all times.

As time passed, rival care service companies entered the market. As a result, CSC experienced increased competition for contracts and it lost some of its care contracts with some government agencies to competitor care providers. Because the award of contracts was partly based on the perception of the company itself, and not just its care quality, Dr Tan came to believe that the governance of the company might be something which should be reconsidered. He believed that the perception of sound governance was necessary to ensure confidence in its services from both its service users and those government bodies outsourcing the service.

Accordingly, he decided to adopt best practice in corporate governance with the creation of a small executive board augmented by the appointment of a number of non-executive directors, along with a committee structure. Natasha Mbana, the current co-ordinator of the company's care services, was made chief executive and Dr Tan proposed that he himself might become the new non-executive chairman. Over time, a total of five non-executive directors were appointed to the board of CSC and they were each paid a small annual fee for their services. All of the non-executives were retired members of large public listed company boards with little experience of public sector service delivery. They all lived in the locality in which CSC was based and Dr Tan believed their presence on the board would look impressive when it came to CSC renewing its service contracts.

As a company fulfilling public sector contracts for care service delivery, pay rates for carers are often relatively low. This also applies to the financial rewards of the senior management in CSC who receive much less in salary and benefits than those with equivalent responsibilities in the private sector. CEO Natasha Mbana says that she accepts a lower level of reward because she believes in the 'public sector ethos' and believes that CSC provides a vital public service. When the new non-executive directors saw what she earned, they noted that she was on much less than the market rate for a chief executive and that she should receive a substantial increase in her rewards to recognise her contribution to the company. Dr Tan said that this might not be possible and that the new non-executive directors should recognise that rewards in the public sector are often much less than those in large listed companies.

Last year, a problem arose for care providers when a small number of companies were exposed by the media for very poor practice. CSC was not implicated in the allegations, but some other companies in the industry were accused of making inadequate or very brief visits to service users, or missing out visiting some service users altogether, under time pressure to see other service users. Most service delivery contracts specified a minimum visit period of 30 minutes per patient and that carers needed to provide a minimum standard of care on each visit, including attending to the service user's personal needs, food, drinks and medication. But because of the pressure to complete their other duties, carers sometimes ignored these minimum periods and thereby failed to fulfil service users' personal needs.

This meant that affected service users were left in discomfort, without food, water and medicines, and sometimes in considerable pain. This caused a lot of anger among the public, and led the country's health minister to ask about the internal controls in care provider companies. The health minister expressed the view that the most vulnerable in society had been let down badly, and the reputation of the care industry was badly damaged. Many companies, including CSC, became aware of public resentment and, in some cases, public hostility.

The manager of 'We care', another care supplier, went on television to explain that there were a number of structural problems with providing care under the government contracts. He said it was difficult to recruit carers and the low pay often meant that it was difficult to retain them. Furthermore, the pressure to deliver the outsourced care services was intense with carers having to hurry from one service user to another to complete their work. It was no surprise, he said, that service users often received less care than they needed because the demands on each carer were so high.

Aware that this scandal threatened the reputation of the whole care services industry, Dr Tan decided that it might be beneficial for CSC to develop and publish a code of ethics which would apply to the company and all of its carers. He was aware that the reputation of all care providers might be affected by the bad practice of a few companies and he wanted to ensure that CSC was well-thought of so it could compete successfully for future contracts and continue to enjoy the support of its service users.

In response to the negative publicity, a number of care providers held a conference and it was decided that Dr Tan, as a doctor and a senior figure in the industry, should write to the health minister on behalf of them all. In particular, they asked Dr Tan to address the issues of the internal controls in care provisions and the measures which providers would be undertaking to ensure there would be no repetition of any bad practices. They thought this a worthwhile measure to attempt to convince the health minister that providers had addressed his concerns.

Required:

(a) Explain the meaning of corporate governance and agency relationships, and contrast how the objectives of corporate governance differs between a large listed company and a smaller company delivering public sector services such as Care Services Company (CSC). (8 marks)

(b) The non-executive directors believed that Natasha Mbana was underpaid in her position as chief executive officer (CEO) of Care Services.

Required:

Explain what 'market rate' means and explain why Natasha Mbana's rewards as CEO of a public sector service provider are likely to be lower than for a CEO of a large listed public company. (10 marks)

(c) Explain the importance of reputation to CSC, and discuss the potential benefits of the proposed corporate code of ethics for CSC. (12 marks)

(d) Draft a letter from Dr Sam Tan to the government health minister, which includes the following:

(i) An explanation of the importance of internal controls in CSC and other care service providers. (8 marks)

(ii) A proposal recommending suitable internal control changes which would help to address the service delivery failures described in the case. (8 marks)

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

(50 marks)

Section B – TWO questions ONLY to be attempted

2 Plantex is a large international pharmaceutical company which has been at the forefront of research into developing cures for many tropical diseases. The nature of its business means that continuous and significant financial investment is required for research and development activities, for which its shareholders expect sizeable returns.

At a recent meeting of the board of Plantex, the finance director, Rachel Tang, submitted a paper on integrated reporting <IR> for discussion and consideration. She advised the board that Plantex had only ever disclosed the minimum information which it was required to by law, but recent developments in the *International Integrated Reporting Framework* has made a very strong case for broadening the amount of published corporate information.

The primary objective of <IR> is to demonstrate the clear link between a firm's competitive strategy, governance system and financial performance, alongside the social, environmental and economic context within which the firm operates. Rachel Tang claimed that by integrating these different areas, the board of Plantex would be in a far better position to allocate its valuable resources more effectively and thereby make more environmental and socially sustainable decisions.

The chairman was highly supportive of the proposal as he had been trying to encourage a corporate citizenship agenda at recent board meetings. He suggested that <IR> would demonstrate that Plantex took corporate social responsibility seriously by being more transparent, accountable and responsive to its stakeholders' demands.

Rachel Tang further asserted that <IR> would have the effect of simplifying published financial information, with excessive detail being removed and critical information being highlighted. If Plantex voluntarily adopted <IR>, its shareholders, and other stakeholders, would better understand how the firm was really performing and so be able to make a meaningful assessment of the firm's long-term strategy. This openness could encourage further investment and strengthen the firm's competitive position.

The chief executive, Stanley Broadway, suggested that this all sounded very good in theory, but he found it hard to justify the extra expense without any recognisable return to shareholders. He said it was 'just another costly management fad that distracted the company from its real purpose – making money for its shareholders!'

Required:

(a) Explain the concept of corporate citizenship and assess the rights and responsibilities of Plantex as a corporate citizen of society. (7 marks)

(b) Describe the differing opinions about integrated reporting <IR> of Rachel Tang and Stanley Broadway and assess them using the relevant Gray, Owen & Adams positions on social responsibility. (6 marks)

(c) (i) Describe the advantages to Plantex and its stakeholders of adopting <IR>. (6 marks)

(ii) Explain how using an <IR> approach will provide information about the six capitals including the resources and relationships on which Plantex depends. (6 marks)

(25 marks)

3 Branscombe Co has been supplying and fitting premium bathrooms and kitchens in hotel chains throughout Effland for the past 20 years. The company started as a small family concern, but because of the rapid growth it experienced and an associated need for additional capital, it was recently listed on the national stock exchange by an initial public offering.

To remain fully compliant with the Effland corporate governance code, the board established audit, remuneration and nomination committees which were solely populated by independent non-executive directors. However, it did not consider it necessary to create a separate risk committee because the board believed that the remit of the audit committee included all aspects of risk management policy. This explanation was formally submitted to the shareholders at its first general meeting, who agreed with the board's proposal.

As part of its expansion strategy, the board of Branscombe Co decided it needed to enter overseas markets, and in particular the developing country of Geeland. The reason that Geeland was selected as a suitable market was because it had experienced rapid economic growth and domestic prosperity following the discovery of rich, offshore mineral deposits. Unfortunately, this small island nation has never enjoyed stable democratic government and is notorious for corrupt business practices, with customs officials regularly demanding bribes from both importers and exporters. As a result, Geeland has a poor international credit rating. In order to attract both domestic and foreign inward investment, the government of Geeland operates with very low levels of indirect tax, which has stimulated the island's tourist industry and led in turn to a significant increase in hotel building.

Following a successful tendering exercise, Branscombe Co was awarded the contract to supply all of the bathroom equipment for a 200-room hotel, currently under construction in a remote area of the island. The total value of the supply contract amounted to Geeland $1,800,000, and it was to be paid in three equal instalments as the bathrooms were delivered to the hotel. The contract assigns responsibility for shipping the goods the 3,000 km from Effland to the island solely with Branscombe Co, and no payment will be made until an agreed volume of goods clears Geeland customs. A further problem is that the Geeland dollar is quite volatile, but recently it has been strengthening against the Effland dollar. As all contract payments are to be made in Geeland currency, Branscombe Co is exposed to foreign exchange risks.

The many contract-related issues amount to significant risks to Branscombe Co requiring effective management if the supply contract is to be a success and contribute to the company's ambitious growth targets.

Required:

(a) Explain the function and roles of a risk committee within an effective corporate governance framework, and discuss the advantages which a risk committee could add to the governance of Branscombe Co. (10 marks)

(b) Explain the term risk appetite, and assess how the risk appetite of Branscombe Co has influenced both its corporate strategy and the risks it has chosen to bear. (7 marks)

(c) Explain how Branscombe Co could effectively control the strategic and operational risks which arise from the Geeland supply contract. (8 marks)

(25 marks)

4 When MRA was shortlisted for a valuable contract for the development of a coastal defence system for another country, it was contingent on the payment of a facilitation fee to an official in the defence ministry. Clearly this was an unusual request but it was also made very clear that MRA would not be awarded the contract, worth $2 billion over 10 years, unless the relatively modest sum of $1 million was paid immediately.

Recently, business activity in the defence sector had been very slow, and MRA was about to announce around 500 staff redundancies. Therefore news that this contract was about to be awarded came as a great relief to the board of MRA, as the jobs would now be secured. However, only the chief executive officer (CEO) and operations director knew about the facilitation fee, so an emergency meeting of the board was convened with only one item on the agenda.

Due to the very sensitive nature of the matter at hand, it was decided not to make a formal record of the discussions at the board meeting. This was more likely to result in a frank exchange of views and encourage all directors to express their opinions openly.

The CEO, Charlie Desborough, explained the dilemma to the board, making it very clear that without this contract there would be no way to protect jobs. The finance director, Jake Neilson, said that he was personally very uncomfortable with the idea of paying a facilitation fee, which was in effect a 'bribe'. As a professional accountant he was bound by a code of ethics which strictly prohibited making such payments, therefore he could not sanction the payment under any circumstances.

The HR director, Sarah Shue, took a far more pragmatic stance. She acknowledged that any form of corruption was utterly deplorable; however, it was a fact of life in many countries. She asserted that if the board of MRA decided not to make the payment and forego the contract, then it could be assured that a competitor would not adopt such a high-minded position. The net effect was that by avoiding a relatively small payment, the firm would be doing a disservice to both its employees and its shareholders, who would undoubtedly suffer a reduction in their shareholder value. She maintained that sometimes it is necessary to take difficult decisions in business that are for the greater good, and so suggested that the payment to the official should be made.

Required:

(a) (i) Compare relativism and absolutism and explain the significance of individual or personal differences in guiding ethical behaviour under each approach in a given scenario such as the situation at MRA. (5 marks)

(ii) Explain the ethical theories of deontology and teleology or consequentialism, and analyse which of the approaches have been adopted by Sarah Shue and Jake Neilson. (6 marks)

The involvement of directors in bribery and corruption can seriously undermine the relationships of trust upon which corporate governance is based.

Required:

(b) (i) Assess how bribery and corruption could undermine confidence and trust in MRA, with reference to the principles of corporate governance. (8 marks)

(ii) Describe best practice measures which could be employed by MRA to combat bribery and corruption. (6 marks)

(25 marks)

End of Question Paper