

Professional Level – Essentials Module

Governance, Risk and Ethics (Singapore)

Wednesday 11 December 2013



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 (SGP)

ACCA

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

- 1 When the 1,000 km Hiaka pipeline in Wyland was built ten years ago, the route took it, overground, the full length of Hiakaisland, one of Wyland's largest offshore islands. Owned and operated by Hiaka Energy Company (HEC), its construction was significantly over budget and suffered lengthy delays, but the pipeline has since become a vital source of economic growth on Hiakaisland and beyond. Its purpose is to connect the oil platforms off the north coast of the island with the deepwater port of Hiakatown in the south. A land pipeline to the south is needed because sea ice in the north prevents shipping access during the winter months. The oil carried by the pipeline is loaded onto several ships each day at Hiakatown port. Most of the oil from Hiakaisland is sent to the neighbouring country of Exland, with oil from Hiakaisland representing 90% of Exland's total oil consumption. Because the contract with HEC is so important to the government of Exland, the terms of supply are subject to legal enforcement with regard to prices charged, delivery terms and the quality of the oil delivered. Because most of its output goes to export, HEC is a major source of foreign currency for Wyland.

Hiakaisland is a globally important natural habitat with a dramatic and rugged terrain. It is monitored by several international scientific agencies, some of which were very critical of the decision to build the pipeline in the first place. It is one of very few locations in which some wildlife species threatened elsewhere are still in abundance. There are healthy populations, for example, of bears, elk and otters. One well-respected international wildlife organisation (called Save Our Wilderness or 'SOW') produced a report saying that the Hiaka pipeline was not environmentally sustainable and that, over time, it would deteriorate and create an unacceptable environmental risk to Hiakaisland. It said that both the company (HEC) and the government of Wyland needed to adopt longer-term time perspectives and consider the potential environmental consequences of the pipeline. The government of Exland, elected every four years, disputed this, saying that SOW's definition of sustainability was too narrow and that it should also consider the economic sustainability of Exland. The position of the board of HEC is that its operations should be 'as sustainable as is economically possible'.

Wyland is a developing country with few labour regulations and very little legislation on employee pay and conditions. This has enabled HEC to use a large proportion of poorly-paid immigrant labour to build and maintain the pipeline, thereby reducing its construction and operating costs. Because of the multinational nature of much of the semi-skilled workforce, there are often language difficulties, especially when conveying messages to staff working on the pipeline and on the oil platforms. HEC has a requirement that all staff should speak the language of Wyland, but this has proven to be impossible to enforce.

As the main employer on Hiakaisland, HEC employs 5,000 people including some on offshore oil platforms, others in the main southern town of Hiakatown, and others still at a number of remote locations the length of the island at strategic points situated along the pipeline. Because of the remoteness of much of the work on Hiakaisland, conditions are harsh for many of these workers. HEC employees often work in freezing temperatures and live in encampments with intermittent logistical support. Motivation and morale are often low among these maintenance employees.

There have been poor industrial relations because of this lack of support. Workers resent the company's management in Hiakatown for their harsh conditions. These poor relationships have also made it difficult for management to try to enforce the Wyland language requirement upon the immigrant labour. The remote locations and poor conditions have also meant that the company has found it difficult to recruit the skilled technical people it needs to inspect and maintain the pipeline. There is a shortage of qualified engineers and technical staff in Wyland, with many preferring to work in the cities rather than in the more difficult conditions on Hiakaisland.

HEC is one of Wyland's biggest businesses and is listed on the Wyland stock exchange. Because of the nature of the energy market, shareholders have come to expect a good annual return on investment in terms of dividends. One market analyst recently commented that a focus on short-term returns has not been good for the company's long-term strategy and that shareholders should be prepared to expect lower dividend yields as a result.

In order to address the many challenges which the company faced, HEC appointed a new chief executive and risk manager last year. Gavin Hoo was appointed chief executive and Gerry Jupp joined as risk manager. Born and educated in a highly developed country, Mr Hoo had a strong track record in the energy industry and took over at HEC on what was considered a good reward package for his home country. On Hiakaisland, however, the level of reward was very large by local standards, making him the highest paid person not just in the company, but in the entire regional economy of Hiakaisland. When the reward figure was later published in the annual report, the local press and some trade unions were angry, believing that his reward was 'outrageous' and that he lived in luxury whilst unskilled immigrant workers 'froze' in the maintenance parties working along the length of the pipeline. Some critics pointed to the fact that it was significantly cheaper to live on Hiakaisland than in the major cities on the Wyland mainland and that this was not reflected in Mr Hoo's rewards at all.

Meanwhile, risk manager Gerry Jupp set about examining the company's many risks. One of his first tasks was to assess some of the risks which may affect the operation of the pipeline, and he took technical advice on these to arrive at probabilities of the risks arising over the next ten years. It was recognised that there was some subjectivity involved in these measurements.

- Risk 1. Risk of terrorist attack on any part of the pipeline causing severe spillage and complete supply disruption: 10%.
- Risk 2. Risk of geological movement and/or earthquake capable of severing the pipeline in more than one place causing severe long-term supply disruption: 5%.
- Risk 3. Risk of technical failure of a joint in the pipeline causing a temporary supply disruption of a few hours but no leakage of oil: 10%.
- Risk 4. Risk of animal or natural damage to pipeline (e.g. by bears, elk or adverse weather) causing superficial damage to pipeline but no disruption to supply: 60%.

Unfortunately, Risk 4 was realised shortly after Gerry Jupp produced his calculations. At the point where it crossed the Gojo river in northern Hiakaisland, the pipeline had a long and unsupported section. During a winter storm, a connection was slightly displaced resulting in a minor oil leak. Although not serious in itself and quickly repaired, the 'Gojo incident' did raise concerns and showed that the pipeline was vulnerable. Seeking to protect both the pipeline and the environment on Hiakaisland, the Wyland government's industry minister wrote to CEO Gavin Hoo asking him to respond to rumours about poor internal controls in HEC and to introduce measures to reduce the chances of a repetition of the Gojo incident.

In response to the industry minister's letter, the HEC board reviewed internal controls and two resolutions were agreed. The first was that the company should establish a formal internal audit function and second, that a full review of any barriers to sound internal controls in the company should be carried out. Although a formal internal audit function was not required by statute law or any stock exchange listing rule in Wyland, the board agreed that it would be good practice, especially if the security and maintenance of the long Hiaka pipeline could be included in the scope (terms of reference) of the internal audit function to be established. It was decided that in responding to the minister, Mr Hoo should convey both the board's resolve on internal audit and also an honest review of the problems for achieving sound internal controls in the unique situation the company was in on Hiakaisland.

Required:

- (a) The term 'sustainability' can be understood in different ways.
 - (i) **Explain the concept of 'sustainable' as used by 'Save our Wilderness' (SOW) and contrast this with the concept of economic sustainability as discussed by the government of Exland.** (4 marks)
 - (ii) **Using information from the case, discuss the tensions which exist between these two concepts.** (8 marks)
- (b) **Assess the four risks described by Gerry Jupp and propose a suitable risk management strategy for each. Briefly explain why subjective judgement may limit the accuracy of his risk assessments.** (10 marks)
- (c) **Briefly explain the meaning of 'labour market conditions' in the context of executive pay and critically evaluate the decision to award Mr Hoo such a high level of reward in comparison with local rates of pay on Hiakaisland.** (10 marks)
- (d) **Prepare the letter from Gavin Hoo, the chief executive of Hiaka Energy Company (HEC), to the Wyland industry minister. The letter should:**
 - (i) **Explain the reasons why the implementation of sound internal controls has been difficult at HEC.** (8 marks)
 - (ii) **Basing your answer on the main roles of internal audit, discuss the ways in which an internal audit function might provide assurances in order to make an effective contribution to HEC.** (6 marks)

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

(50 marks)

Section B – TWO questions ONLY to be attempted

- 2 The Sarbanes-Oxley legislation in the United States was introduced in 2002, partly in response to the earlier failure of the American energy company, Enron. It was decided by United States legislators that compliance should be enforceable under law rather than under listing rules. At the time it was being debated, some said that the legal enforceability of Sarbanes-Oxley would be unfair to smaller companies without the infrastructure needed to generate internal control data and to report on it. One example of this was the debate over s.404 of Sarbanes-Oxley, which mandated external reporting on the adequacy of internal controls. Before a size criterion was later introduced, this applied equally to all companies but now smaller companies are partly exempted from this requirement.

In its advice on this requirement, the United States Securities and Exchange Commission (SEC) published the following comments:

The rules we adopted in June 2003 to implement s.404 of the Sarbanes-Oxley Act of 2002 ('Sarbanes-Oxley') require management to annually evaluate whether internal control over financial reporting (ICFR) is effective at providing reasonable assurance and to disclose its assessment to investors. Management is responsible for maintaining evidential matter, including documentation, to provide reasonable support for its assessment. This evidence will also allow a third party, such as the company's external auditor, to consider the work performed by management.

Required:

- (a) Distinguish between rules and principles-based approaches to the regulation of corporate governance, and explain the disadvantages of a rules-based system such as Sarbanes-Oxley in the United States. (7 marks)
- (b) Define 'agency' in the context of corporate governance and discuss the benefits to shareholders of 'maintaining a system of internal control over financial reporting' in a rules-based jurisdiction. (10 marks)
- (c) Construct the case to exempt smaller companies from the full reporting requirements of s.404 of the Sarbanes-Oxley Act 2002. (8 marks)

(25 marks)

- 3** 'Help-with-life' (HWL) is a charitable organisation established ten years ago. Its stated purpose is, 'to help individuals and families with social problems and related issues.' Its work, in a large city with people from many countries and backgrounds, involves advising, counselling, giving practical support to service users (the people who come for help). Over the years it has been operating, HWL has realised that the best outcomes are achieved when the staff member understands and sympathises with the service users' social norms, ethical and cultural beliefs.

40% of HWL's funding comes from local government. This means that HWL has to account for its use of that portion of its funding and comply with several rules imposed by local government. One of these rules concerns demonstrating appropriate diversity amongst the managers of services such as those delivered by HWL. It requires the charity management team to involve the widest feasible range of people and to reflect the demographic make-up of the community.

HWL has recently had to replace a number of executive and non-executive members of its board. The external auditor suggested that setting up a nominations committee would help in these board appointments. The CEO, Marian Ngogo, has always stressed that all directors should share the ethical values of HWL and agree to take reduced rewards because, 'every dollar we pay a director is a dollar less we are spending on service delivery.' She stressed that the culture in a charity was very different from a commercial ('for profit') business and that staff and directors must share the ethical stance of HWL and had to accept a different approach to social responsibility if they joined.

Required:

- (a) Explain the roles of a nominations committee and describe how the Help-with-life (HWL) nominations committee might approach the task of nominating and appointing new directors.** (8 marks)
- (b) Explain the advantages of diversity on the board of HWL.** (8 marks)
- (c) Explain 'corporate social responsibility' (CSR) and discuss the ways in which CSR and the ethical stance might differ between HWL and a commercial 'for profit' business.** (9 marks)

(25 marks)

- 4 A technological failure occurred at Lobo Company last year. A new computer system which was designed to control Lobo's complicated operational facility broke down shortly after it was installed. This meant that the company was unable to carry out production processes normally for several days.

The cause of the failure was later found to have been a system specification error made by Frank Bub, the operations director and a professional engineer. He had seriously miscalculated the capacity needed for the new system and had ordered a computer system which was unfit for purpose. Not only had this resulted in the loss of several days of production and a loss of loyalty and goodwill from customers and others, it also cost a large amount to repair and upgrade the system to be able to cope with the actual demands placed upon it.

Frank Bub acknowledged that he had over-ridden normal procurement procedures in purchasing the system. But he was thought by his colleagues to be such a competent engineer, it was not felt necessary for anybody else in the company to discuss the purchase with the suppliers. His fellow directors believed that Mr Bub would exercise the judgement needed to purchase and implement the new system. Because the system was needed urgently, there was no time to run it in 'pilot mode' or to test it on site before it was fully installed. When he was asked about the failure, Frank Bub said that he decided to buy the system in question because an old friend had recommended it and that he saw no need to take further advice beyond that.

The non-executive directors met after the incident and collectively decided that Frank Bub, who had nine months remaining on his renewable three year contract, had lost the confidence of the board and should leave the company at the earliest opportunity. It was decided to move him to a non-critical role until such time as it was possible to remove him as cheaply as possible.

Required:

- (a) Directors may leave the service of a board in several ways.

(i) **Describe the main ways in which the directors of companies can leave the service of a board.**

(3 marks)

(ii) **Justify an appropriate way for Frank Bub to leave the board of Lobo Company, based on the circumstances of the case.**

(5 marks)

- (b) **Briefly explain 'technological risk' and discuss the problems which led to the technological failure at Lobo, commenting on how these might affect shareholder confidence in the entire board.**

(8 marks)

- (c) You may assume that, as a professional engineer, Frank Bub is bound by the same fundamental principles of professional ethics as a professional accountant and must act in the wider public interest.

Required:

Discuss the fundamental principles of professional ethics which Frank Bub failed to observe and explain how an awareness of his duty to the public interest may have prevented his errors.

(9 marks)

(25 marks)

End of Question Paper