

Professional Level – Essentials Module

Governance, Risk and Ethics

March/June 2018 – Sample Questions



Time allowed: 3 hours 15 minutes

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.

This question paper must not be removed from the examination hall.

P1 Paper

Think Ahead

ACCA

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Accountants

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

- 1 Henry & Williams (HW) Bank is the largest bank in its own country by market value. In the summer of 2017, it came to light that branch managers secretly created bank and credit card accounts in the names of existing customers without their customers knowing and charging fees to those customers for unwanted additional accounts.

It emerged that the branch managers were paid a bonus on the achievement of sales targets and enticed by the promise of large rewards, some of the managers had been prepared to do whatever was needed to deliver the required number of sales. Branch employees had been prepared to go along with the manipulation due to the fear of losing their jobs and the promise of promotion if they did not question the instructions from their line managers.

Funds were moved from customer accounts into newly created ones without their consent. Customers were being charged for insufficient funds, or incurred lost interest because the amount left in their original account had been reduced. In many cases the customer had no knowledge of the transactions being created on their behalf. This led to over one million fake accounts being opened which individual customers had never authorised.

Branch employees also used a database to identify customers who had been pre-approved for credit cards and then ordered the card without the customers' consent. Over a three-year period managers coached bank employees on how to inflate sales numbers through the creation of fraudulent bank accounts and credit cards.

Regional bosses put pressure on bank managers to progress towards their weekly quotas for opening accounts and selling customers extras such as overdraft protection. Relentless pressure to meet targets encouraged manipulation and ethical breaches. The fictitious accounts earned HW Bank enormous fees, and allowed bank employees to boost their commission figures and make more money for themselves in the process. The managers were motivated by unrealistic sales quotas and the self-serving motives of the managers meant they would ignore the customer complaints because as long as the sales targets were achieved they saw the outcome as win:win, gaining bonuses for themselves and earning fees for HW Bank. The managers paid insufficient attention to the potential reputational risk for the bank which might arise due to their fraudulent activities being discovered.

The issue was highlighted when defrauded customers started noticing they were being charged unexpected fees, or received credit or debit cards in the mail which they did not request. Initially the individual complaints were resolved internally, at branch level to appease those customers who had discovered the irregularities, therefore preventing a wider awareness of the scale of the complaints and keeping the scandal out of the public eye. The systemic problem only came to light after an internal investigation took place into why a considerable number of customers were leaving HW Bank. The investigation revealed that their customers were switching to alternative banks where they felt their accounts would be safer. After the internal investigation, the bank dismissed around 2,000 employees (around 3% of the workforce) whom they held responsible for the unauthorised and unethical behaviour.

It has also come to light that during the three-year period an employee had invoked HW Bank's whistle blowing procedure and had disclosed that he had been instructed by his manager to manipulate transactions and misrepresent the bank's performance. HW Bank's auditors produced a report for the regulator rejecting the whistle blower's allegations outright. The regulator has now revealed that the summary report it received had omitted key documents and evidence which had affected its ability to take the matter further.

HW Bank's chief executive officer (CEO), who is also the chairman, issued a press statement which reads:

'Our entire culture is centred on what is right for the customer. We make ethical conduct a priority and will continue to punish or dismiss employees who don't serve customers properly. We have historically managed risk well, especially credit risk and market risk, which can be measured and monitored. However, the risk of unethical business practices creating operational, reputational and regulatory risk for the bank is not easily managed. The board was unaware of the employees' actions. The branch managers carried out these transactions without the approval of the board and therefore the board cannot be held responsible.'

The institutional investors who own 80% of the shareholding in HW Bank are unhappy because HW Bank is now facing substantial fines, the share price has fallen and market share has been eroded by competitors who have exploited the reputational impact HW Bank has suffered because of the unethical behaviour. They are also disappointed that reporting has not been completely transparent. Reports from the nominations committee have never revealed that the non-executives serving on the board were selected by the current executives. Reports from the remuneration committee have always shown one total remuneration figure for each non-executive and so investors were unaware that the total remuneration included a bonus based on HW Bank's performance. The shareholders have demanded a

general meeting to discuss the unethical behaviour which has taken place. In particular, the shareholders want to hear the CEO explain how he allowed the creation of unauthorised accounts to continue unchecked for three years.

Required:

- (a) **Using information from the case, identify and analyse the internal control failures which gave rise to the unethical behaviour at HW Bank.** (10 marks)
- (b) HW Bank's board failed to identify the degree to which operational, regulatory and reputational risk could have an impact on the organisation.

Required:

- (i) **Explain each of the risks and the impact for HW Bank of the board failing to manage them.** (6 marks)
- (ii) **Discuss how applying sound corporate governance at HW Bank could help support better internal control and risk management.** (10 marks)
- (c) **Explain the purpose of a general meeting and the advantages for the shareholders of a general meeting to discuss the issues raised by the unethical behaviour at HW Bank.** (6 marks)
- (d) **Draft a memo from the CEO to the senior managers at HW Bank. The memo should include the following:**
- (i) **An explanation of the information which the board needs to include in the next external report on internal controls and risk.** (6 marks)
- (ii) **An assessment, based on the information in the case study, of the importance for the board of HW Bank to have all the information relating to key operational risks and controls.** (8 marks)

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

(50 marks)

Section B – TWO questions ONLY to be attempted

- 2 Kramp Telecoms, an international mobile network provider, has been victim to several cyber-attacks* in recent months. On the last occasion over 40,000 customer accounts were hacked and significant amounts of personal information were extracted by unknown parties. This one incident has brought into question the effectiveness of the security of Kramp's information systems.

Because of the scale of the recent hacking, there has been considerable media criticism of Kramp. Customers are demanding that the company takes immediate action to investigate in full what happened and implement measures to strengthen the security of its systems. Many customers have already cancelled their contracts with Kramp Telecoms and moved to competitors who have not experienced similar hacking. A further impact is that the company's share price has fallen by 25% since the cyber-attack occurred, which has raised alarm among shareholders.

Concerned with the reputational and business harm which the cyber-attacks have caused, the board of Kramp has constituted a risk committee. It comprises senior and experienced operational managers as well as experts in the field of cyber-security. The committee has been specifically tasked by the board with identifying the main cyber risks which the company currently faces, classifying and prioritising them, and then recommending appropriate mitigation strategies.

**A cyber-attack is a malicious action by individuals, groups, organisations or even nation-states which targets computerised information systems with the aim of stealing, altering, or even destroying targeted information by hacking into a susceptible system.*

Required:

- (a) **Identify the most significant risks which Kramp Telecoms faces from the threat of further cyber-attacks, classifying them and assessing their potential impact.** (8 marks)
- (b) **Recommend appropriate strategies to mitigate/manage the cyber-attack risks facing Kramp Telecoms using the TARA framework.** (8 marks)
- (c) **Explain the importance of risk awareness at all levels in Kramp Telecoms and advise how risk awareness could be embedded into its corporate culture.** (9 marks)

(25 marks)

- 3** Harry Larsen, a qualified accountant, is leading an internal audit team at Bedruch Co investigating why a major project is currently incurring high costs and overrunning its planned deadlines for completion. Larsen's girlfriend is the project manager, although no-one else in the company knows about their relationship.

The project is critical to moving customers from a slow and old computer system to a new customer relationship management (CRM) system where all data held on customers can be integrated, and more easily accessed and analysed. If the project looks likely to incur further significant cost overruns, it is likely to be cancelled by the board, as it will not represent value for money. However, if the project is not completed, many members of staff, including Larsen's girlfriend, are likely to lose their jobs.

Larsen is under pressure to report to the audit committee on his team's evaluation of the project. Should he conclude and report that the project is no longer viable, it will be immediately terminated. Larsen's girlfriend is very aware of his predicament and is putting immense pressure on him to misrepresent the true status of the CRM project. She expects her boyfriend to write a favourable report to the audit committee and recommend that the project should be allowed to complete as planned.

Bedruch Co does not have its own corporate code of conduct. However, as a qualified accountant, Harry Larsen is reliant on his professional judgement when deciding what to do next.

Required:

- (a) **Explain the nature of professionalism as an accountant, and how it should influence the behaviour and actions of Harry Larsen, both as a professional accountant and leader of the internal audit team at Bedruch Co.** (8 marks)
- (b) **Evaluate the ethical threats currently faced by Harry Larsen, and discuss possible safeguards which could have helped to prevent this situation.** (9 marks)
- (c) **Using the American Accounting Association model, describe how Harry Larsen could have resolved his ethical dilemma and maintained his professionalism, and recommend what he should do next.** (8 marks)

(25 marks)

- 4 XSport is a large and very successful sports equipment retailer based in Laland, and listed on its stock exchange. It has grown substantially over the last 25 years, dominating its core market by offering branded goods at highly competitive prices. It maintains a low-cost base by importing over 90% of its inventory from low cost economies, and selling them through an extensive network of retail outlets. Five years ago, the board of XSport decided to open a large number of stores in several neighbouring countries, because they were in the same customs union and so did not charge any import tariffs. These stores have proved to be a great commercial success and they now contribute over 25% of company revenue, and 30% of profit.

However, recently the electorate of Laland voted to leave the customs union which the country had been a member of for nearly 50 years. The outcome of the referendum has led to economic uncertainty, most notably in the devaluation of the Laland currency. Because of the weakening currency, the cost of paying for imported goods for XSport has increased by nearly 20% since the vote to leave the customs union, and this is squeezing its already tight profit margins. The actual withdrawal from the customs union will take several years to complete. However, withdrawal will mean that tariffs will be imposed on all sales made in XSport stores in the neighbouring countries as they are remaining members of the customs union, and goods they sell will be imported from Laland.

XSport was originally established by Christian Harper, a charismatic individual who still holds 40% of its shares and is the current chief executive officer. He is quite a dominating man, who exerts disproportionate influence over all board decisions. He did not see the need for the board to establish a dedicated risk committee as the company had grown from strength to strength, so it has no strategy in place to deal with the economic difficulties it faces arising from recent political events.

Required:

- (a) **Explain the concept of risk attitude, and assess how it has been influenced at XSport.** (6 marks)
- (b) **Explain the dynamic nature of risk assessment, and advise why and how XSport needs to respond to the changing risks emerging from its economic and political environments.** (9 marks)
- (c) **Explain the role and responsibilities of a risk committee at XSport, and discuss how a risk committee made up solely of non-executive directors could improve the effectiveness of corporate governance arrangements.** (10 marks)

(25 marks)

End of Question Paper