
Answers

1 (a) Internal control failures

Poor control environment

The overall tone relating to internal controls set by management should be one of a positive and supportive attitude. HW Bank branch managers failed to demonstrate this attitude, lacking personal integrity which allowed them to be unconcerned about maintaining an effective control environment.

The control environment provides the discipline and structure for the achievement and approach to internal control. The management philosophy and culture at HW Bank was openly tolerant of the unethical activities. Managers not only accepted the activities, they actually encouraged them.

Lack of risk assessment

The level of risk associated with the commercial practices of HW Bank should be assessed in order to determine how the risk should be managed. The risk assessment failed to reveal how unrealistic and reckless the sales goals were.

Employees were put into a risk/reward trade off position which forced them to choose between customer well-being and their own interests. Employees were motivated by unrealistic sales quotas with no oversight of the remuneration they achieved through participating in fraudulent practices. The branch managers promoted activities which had the potential to give rise to serious reputational damage.

Inadequate control activities

Internal controls should have been embedded into the operations of HW Bank. The bank appears to have a lack of checks and balances which allowed unauthorised bank and credit card accounts to be opened without customers knowing.

Management was prepared to look the other way and there was no mitigation process to protect against customer account manipulation and the opening of over one million new accounts over a three-year period.

Lack of information and communication

Information needs to be gathered and communicated to the right people so they can carry out their responsibilities. There appears to be no analysis of information which would have highlighted a trend in customer queries and complaints.

The board was not receiving adequate information flows on significant risk indicators, for example, the level of complaints. There was no appropriate measurement system which triggered a signal to the board that the rate had risen to an unacceptable level. The lack of information meant inaction on the part of the board. The board also failed to act, or at worst ignored the information supplied by the 'whistle blower'.

Inadequate monitoring

The internal control system would normally be checked by independent auditors to ensure that it is working. The auditors appear to be complicit or at least negligent as they prepared reports for the regulator which omitted key documents and evidence. Additionally, as only 3% of employees were dismissed, it suggests that this behaviour was not spread across all branches and unusually high sales in some branches, compared to others, should have triggered closer monitoring and investigation.

The directors have failed in their fiduciary duty to monitor the effectiveness of the internal control and risk systems and although they may delegate some of their duties to the audit committee and the external auditors, they are still accountable to the shareholders for ensuring adequate systems are in place. The directors' suggestion that they did not know what was happening cannot be considered a valid excuse, and they have been negligent in protecting the shareholders' investment.

(b) (i) Operational risk

This is the risk connected with the internal resources, systems, processes, and employees of the bank. The risk arises from inadequate or failed internal processes and will be associated with decisions relating to how the bank functions and what it prioritises.

The impact of failing to manage the risk has allowed for unchecked incentives which have resulted in employee fraud and misconduct. The bank will need to undertake a complete overhaul of its policies, standards of behaviour and performance and rewards systems.

Regulatory risk

This is the risk arising from the possibility that regulations will affect the way the bank has to operate. The regulators will now make judgements about the robustness of the bank's business model and the suitability of their selling methods.

The consequences of failing to manage the risk are likely to mean significant changes in the methods of selling and the cost structure of the business. The bank is now facing substantial fines and having not reported the true situation in the report on the whistle blowing investigation, it is likely to find it is investigated and interrogated on a more regular basis. The regulator is likely to intervene more promptly if it sees or anticipates any future problems.

Reputational risk

This is the risk arising from an adverse effect on brand image or product reputation. It is a negative perception by stakeholders. It is important that the bank is seen by stakeholders as competent, ethical, fair and reputable. Any loss of this perception would impact its ability to retain existing customers, or attract new customers.

The bank's external brand has now been affected by internal failings. The impact is that the bank's customers now have a lack of confidence in the bank's ability to manage their investments. Customers are switching to the competition and market share is being eroded, which could affect its ability to operate in the future if customers are avoiding them.

- (ii) A sound system of corporate governance is capable of supporting better internal control and risk management in a number of ways.

An effective structure for managing internal control and risk management

Sound governance will promote the need for an effective board of directors. Non-executives should independently and effectively ensure that the management of the company is properly held to account. Having an effective non-executive presence on the board means the shareholders' interests are represented in board discussions. More independent NEDs would have ensured independent scrutiny of the executives. The increased questioning of the executives may have uncovered the failures earlier and minimised the financial loss which HW Bank incurred.

The non-executives were benefiting from the increase in business brought about by the fraudulent activity which created a conflict of interest and a lack of motivation to resolve the fraudulent activities. Any performance based remuneration for non-executives has significant potential to conflict with their primary role as an independent representative of shareholders. In order for the non-executives to remain objective, their pay should never be linked to profits.

The presence of a strong independent person able to exercise the role of chairman, whose role is to encourage openness and debate on issues in board meetings, is essential. The chairman would ensure that accurate and clear information was circulated and could expose unethical behaviour like that demonstrated by the branch managers. The presence of a non-executive chairman would have offered someone to confide in and to communicate with about any concerns on inappropriate sales targets and the culture of pressurised sales techniques.

Aligning the interest of management with those of the shareholders is key. This reduces the agency problem and makes it less likely that management will promote their own self-interests above those of shareholders. Mechanisms for consulting shareholders and mutually agreeing objectives should be put in place. By promoting longer-term shareholder interests over personal or short-term gains, HW Bank is less likely to come under the ethical pressures which might have led to failure.

Formal procedures for risk management

A sound system helps to identify and manage the wide range of risks which HW Bank faces by specifying a formal set of procedures for risk management. The risk management process should consist of several stages, including risk identification, risk assessment, the development of risk controls in response to how the risks are assessed and a process of review and feedback on the effectiveness of the controls.

Governance would support embedding the risk management systems into human resource systems such as job descriptions and appraisals. They should become normalised into the bank employees' work roles and be considered nothing out of the ordinary. If the integrity and ethical failures were considered as misconduct in HW Bank's disciplinary policies, the ethical tone in the bank may have been improved.

A risk committee would raise awareness and encourage appropriate risk management within the bank. The committee would review any threats to the bank's position and advise the board on the risk profile and appetite of the bank, making recommendations on all significant matters relating to risk strategy and policies.

Robust internal controls

Effective governance will ensure a range of robust internal controls which will ensure the effective use of resources and the minimisation of fraud and misuse of company assets which occurred at HW Bank. In HW Bank, introducing customer authorisation to open new accounts and a review by internal audit of unusual patterns of activity and fees might have prevented the fraudulent activity.

The absence of controls has led to the conditions experienced by HW Bank. Implementing effective controls will promote efficient and effective operations in the future. The absence of controls in the future could lead to conditions which threaten the bank's survival.

Transparent reporting to support advanced warning of control issues

Governance codes encourage reliable, complete and transparent reporting so that investors can establish what is going on in the bank and will have advanced warning of any problems. The responsibility of the board is to ensure effective control of the bank's finances, operations and compliance and any other areas of the business activity and to report on the effectiveness. The need to report creates an accountability of management to shareholders and should restrict the type of actions and behaviours seen at HW Bank.

(c) General meeting

Most companies hold an annual general meeting once a year to present the affairs of the company to its shareholders. There are also irregularly held general meetings, which are meetings arranged to approve events which require a special resolution for each substantial issue. General meetings are usually called on an 'as required' basis. All shareholders must be notified and are entitled to attend. General meetings are usually called where an issue arises which is too serious or urgent to wait until the next annual general meeting.

Shareholder reassurance

The shareholders can gain reassurance that the latest scandal relating to the creation of unauthorised customer accounts will not threaten shareholder value as a consequence of the damaged reputation of HW Bank. The shareholders will need to be confident that the future strategic direction of the bank will be in keeping with their wishes and that any unethical behaviour has been eliminated. They will want assurances that adequate returns can continue to be achieved.

Governance failures

The shareholders can hold the CEO to account for his actions and demand explanations. The shareholders would expect the CEO to remain responsible for the effective internal control and risk systems. The shareholders can question the CEO on his failure to implement appropriate systems and how the unethical behaviour was allowed to continue for three years. There are also issues with the governance arrangements. For example, the lack of independence of the non-executives has now come to light and the shareholders will need to be reassured that this will be addressed.

Face to face communication

The CEO will be able to speak directly to shareholders, rather than through written communication and this may be a more convincing way of explaining the position. Given the shareholders want to hear from him directly, the general meeting will enable him to address their demands.

Removal of directors

Resolutions of confidence and no confidence can be passed if proposed and this would 'clear the air' one way or the other to enable the bank to resolve its issues quickly. Shareholders have the right to remove the CEO and the non-executives if they are not satisfied with their explanations and this could be resolved now rather than waiting for the annual general meeting.

(d) From: CEO

To: Senior managers

Date: Today

Subject: Increased transparency in information is required to restore trust

In light of the recent malpractice in a number of branches and the loss of public support as a result, decisive action is needed to rebuild our reputation. It is with this in mind that I am writing to all senior managers about the importance of strengthening the information flows and reporting on internal controls and risk management and I am looking for your support in this.

(i) Information to be included in the next report on risk and control

Our immediate and highest priority is to restore trust. To help with this reassurance the board will need to include a statement acknowledging our responsibility for the failure of the bank's system of internal control and for reviewing its effectiveness. It is important for us to recognise this responsibility and set the correct 'tone at the top'. It is only when the board accepts and acknowledges this responsibility that the impetus for the flow of information and the authority for changing the internal control system is provided. The 'tone from the top' is very important in the development of any proposed reporting changes and so this is a very necessary component of the report.

The report will also include summary information on the process being used in reviewing the effectiveness of the bank's system of internal control. As part of our review of effectiveness in the future, we require senior bank managers to sign a confirmation of compliance with procedures and to report any breakdowns, or exceptions, to those procedures.

HW Bank shareholders will be interested in hearing how risks are being controlled and mitigated, especially following recent events. The risk report will contain a description of the significant risks encountered and uncertainties facing the bank at the date of the report. The report will also explain the strategy adopted to mitigate and control the risk. By studying this information, shareholders can decide if they believe each control to be adequate for the control of the risk. This should include the importance of strengthening long-term relationships with our customers and the processes in place, to ensure that the services delivered to customers are of an appropriate standard. The report should state the measures which are in place to restore the reputation if the bank is going to avoid any longer term damage to its name.

We will need to reassure the shareholders that over the coming year we will continue to regularly monitor the ongoing progress of our action plans against key risks. We will review our activities in the light of regulatory and best practice requirements and report any findings on a timely basis to the shareholders.

This brings me to the second part of my communication.

(ii) Information flows relating to key operational risks and controls

I feel that one of the main contributing factors in the recent scandal was a lack of information flows on relevant issues. It is vital that you are reminded about the critical requirement for the board to have relevant information delivered promptly, regardless of the inconvenience which it may cause to you or your direct reports.

In the first instance, it is an important part of governance recommendations that the board put in place a robust system of risk and control. As CEO I have overall responsibility to ensure effective controls are in place to protect shareholders' investment. I have already stated that it is important to begin with the 'tone at the top'. As we have learnt, to our detriment, the latest scandal has caused commercial and reputational loss. The effective flow of important information on controls and risk is of vital importance as an early warning signal. The timely receipt of information and the appropriate response to information is not only important to the safe operation of customer accounts but also to the bank itself.

The board needs to gather evidence that HW Bank's failings have been addressed. It needs timely information on any customer complaints received and how these have been addressed, including information on whistle blowing procedures, and any incidents which have been reported and the responses taken. This will ensure that the problems which were highlighted when the malpractice came to light have now been resolved. This will be important information to reassure the regulators that compliance with regulations is embedded into HW Bank's culture.

The board needs to understand the key significant risks which could materialise in branches so that they can be addressed. It is important that more pro-active monitoring is undertaken at branch levels. Information is needed which enables the board to monitor the performance of the branches on critical issues highlighted. This would include receiving regular information on the number of accounts opened and products sold to customers so that any unusual trends or activities can be investigated at the earliest possible opportunity. It is also important that we reverse the current trend of customers leaving the bank. Receiving information on customer retention and exceptional customer experiences would support the re-building of lifelong customer relationships.

The board is also responsible for managing strategic risks. We need to make informed business decisions on issues which impact the reputation and credibility of HW Bank. If we are receiving incomplete information, then we will not be in full possession of the necessary facts to allocate resources in the most effective and efficient way in order to minimise the impact of these risks.

You will be aware that at board level we have the responsibility to shareholders of giving reasonable assurance that their investment is being safeguarded. Best practice reporting means that we have to provide information on improvement measures and we need good information flows to enable us to do this.

Enhanced oversight of the sales process, reinforcement of the right culture at HW Bank and maintaining the highest level of integrity and ethics all need to be measured and reported on. It is important that we learn the necessary lessons and overhaul our performance in order to regain trust and earn relationships which will be important for our future success.

I trust you will take on board all that I have outlined in this memo and look forward to receiving better, more transparent information in the future.

- 2 (a) The recent cyber-attack on its core systems exposed Kramp Telecoms to several risks should a similar event recur. These include the following:

Technological risk

The latest incident clearly illustrates that because Kramp operates through the internet, it exposes its internal systems to unauthorised access, or hacking. This has resulted in a risk to the integrity of these core technological systems and the data contained within them, which is fundamental to the business operations of the company. The key technological risk is the fact that potentially millions of personal and financial data about private individuals are held on a database or databases which rely for their integrity on systems which are protected by encryption software. This may be vulnerable to attacks from dishonest computer specialists with the expertise or opportunity and motivation to carry them out.

Product/service risk

The financial losses which arise from operating a poor-quality service are already evident at Kramp from the recent cyber-attack. The lack of effective security measures to protect confidential and sensitive information held about its customers is a fundamental flaw in its operating systems, and does not inspire confidence. Should another attack occur, then it is likely that there will be further loss of sales and a need to compensate the affected customers. Also, it may be necessary to financially motivate the remaining customers to stay with Kramp by offering discounts and added services free of charge, thereby incurring further avoidable costs.

Legal/regulatory risk

The mobile phone industry is likely to be a highly-regulated business sector, so any breach of regulation or associated legislation (e.g. consumer protection) could have very serious consequences for Kramp. Indeed, it is likely that the recent cyber-attack and consequential harm caused to customers will result in financial and other penalties being imposed on the company. Therefore, should a similar harmful event be permitted to occur, it is probable that the authorities will take further and more severe sanctions which could ultimately result in the withdrawal of Kramp's operating licence.

Reputational risk

Kramp's apparent failure to adequately protect electronic information has harmed its reputation as a reliable mobile network service provider. This is because reputational risk is directly correlated to other risks, such as technological risk, since its level depends in part on the likelihood of the other risk occurring. Similarly, should reputational risk arise it will directly impact on the value of the company so resulting in financial risk. The loss in revenue which would occur with customers ending their contracts with Kramp would reduce its cash flow, damaging liquidity and increasing the risk of insolvency. This would impact

negatively on profitability because the indirect cost base would not proportionally reduce with sales, and the company would incur additional unforeseen costs (e.g. fines).

All the risks discussed above should be classified as strategic in nature, as they fundamentally relate to the future of Kramp Telecoms. They also illustrate event interdependency, because they will all arise from any further significant adverse event, such as another cyber-attack. Therefore, it is imperative that the causes of these risks are addressed by the directors of Kramp as a matter of priority.

- (b) There are various strategies which could be employed by Kramp Telecom to mitigate the inter-related risks which arise from a further cyber-attack on its systems, which can be described using the TARA framework. This approach requires all risks to be analysed in terms of their likelihood of occurring and their impact on business operations and performance.

Transfer

When the likelihood of the risk recurring is low but the impact is high, then measures should be taken to see if any of the risk can be transferred to another party. This should include a review of insurance policies and the adequacy of cover for any future losses which may arise from a further cyber-attack. However, based on Kramp's recent track record, the premium payable for such a policy would be extremely high. This strategy would therefore need measures to be taken to improve security to a level at which the insurers would reduce the premium to an acceptable level. Transfer could also involve finding someone better qualified to manage the risk to its network – but given the assumed size of Kramp this is unlikely.

Avoid

The presumption is that the risks evaluated are controllable, otherwise the options are to either accept them (see below) or to avoid the activities which cause the risks. Both strategies are unrealistic in this situation. The nature of Kramp's business operations is that it must contract with many customers dispersed internationally. Logistically it would not be feasible to manage its large customer base except through the internet, so it must maintain its internal systems to be able to function effectively as a commercial business.

Reduce

This strategy is when the company takes immediate action to reduce the likelihood of any future cyber-attack occurring to a lower level. This will involve a thorough investigation of how the recent cyber-attack happened, and how the systems were specifically affected or compromised, to identify any apparent weaknesses in software codes. This would lead to the implementation of appropriate measures to strengthen the security of its systems and integrity of the data held on them.

It is possible that however much is spent on improving the security of the systems, the expertise of 'hackers' is likely to evolve, meaning that some elements of significant risk might be ever present. However, the portfolio of correlated risks identified is likely to be judged by the board of Kramp as being the most significant issue now, and so will form the focus of any risk reduction measures and resources assigned. This would be the most likely risk response strategy to adopt.

Accept

This strategy would only be recommended when the scales of the risks identified are so low that they fall within the company's risk appetite. It is apparent from the information given that the cyber-attacks present such a significant strategic risk to Kramp, that accepting them is not an option. Should such an incident recur, then the consequences to the business could be calamitous, so considerable resources must be invested in improving the security of internal technological systems.

- (c) In any organisation, risk awareness is a key governance element, with strategic plans formulated after the thorough and relevant identification of associated risks. Therefore, risk awareness needs to be embedded in all aspects of Kramp Telecoms procedures, systems, structures and corporate culture if the business is going to remain successful. Risk awareness will form part of the company's internal control environment and provide the background against which all internal controls are operated. There are several cultural factors which affect the extent to which risk management can be embedded into the values of an organisation including:
- (i) Increasing the level of commitment to risk management policies, promoted by the board;
 - (ii) determining the risk appetite of the company, and the need to deliver an acceptable level of returns to shareholders; and
 - (iii) assessing whether the culture is open or closed to new ideas, and willing to embrace change.

The fact that the recent cyber-attack has caused such great harm to the company should alert all employees at all levels that they need to remain vigilant to ever present risks posed by such events. The success of the business, and even its going concern status, is threatened by any future cyber-attacks. This should motivate staff to become more aware of the risks in their areas of the business, particularly if any performance related financial remuneration and even job security is related to avoiding further unnecessary risks which could potentially damage the business.

Risk management needs to be embedded into policies and procedures in Kramp Telecoms, but this may still fail unless all employees at all levels accept the need for risk management. Adopting the methodology suggested in the COSO framework means that risk awareness could be embedded throughout the organisation from top down. Whether or not fully adopted, it is essential that risk management is inculcated into the corporate culture and core values so that risk management is considered as normal business practice for the company. Measures which could be employed to embed risk awareness into Kramp include:

Codification

Risk responsibilities should be included within formal job descriptions, which means that employees at all levels have their risk responsibilities clearly and unambiguously defined. Over time risk will become an important aspect of everyone's role and so it will become embedded in the corporate paradigm.

Risk awareness could be further rooted into the business by using a risk register that identifies and prioritises the main risks facing the company. The register assigns named individuals (or departments) with the responsibility for dealing with the risks and taking appropriate action. By codifying risk management, it will become a normal feature of business activity and so will be inculcated into the corporate culture.

Training

The company should issue a risk policy statement and communicate it to all staff. The statement must clarify the policies and strategies adopted by Kramp for the management of risks, and inform how these are controlled. Although a general statement, it sets out the corporate risk management philosophy and should directly influence all aspects of company activities.

Training of staff at all levels to alert them to the risks of cyber-attacks is essential in ensuring that risk awareness is embedded throughout the organisation. Developing risk awareness training programmes, or including risk awareness as a standard component of all training delivered, should increase the level of alertness among all staff.

Organisation

Establishing metrics and performance indicators which monitor and feed back information on risks to management is important. This would ensure that accurate information is always available to the risk committee and the board, and remove any incentive to hide relevant information or fail to disclose risky behaviour or poor practice.

Risk awareness and risk management messages must be communicated to staff, including publishing success stories. Key to the successful dissemination of best practice is internal communications as this helps to develop a risk aware culture by regularly reminding staff of key risk messages. A suggestion box is another simple way of engaging with staff and obtaining feedback for management.

Goals and rewards

Management should align individual goals with those of the company, building them in as part of the corporate culture. The need for alignment is particularly important because risk awareness must be a part of the norms and unquestioned assumptions of the organisation and its staff. Staff which assume ownership of particular risks must have the authority and responsibility to take action to avoid or mitigate them, with reward systems used to raise the profile of risk management and motivate their performance.

3 (a) Professionalism

Professionalism requires everyone to perform their duties honestly and diligently, whilst maintaining the highest standards of professional ethics in the workplace. Professionalism is important at all levels because it leads to improved company standards of behaviour and can help to nurture better relationships between colleagues. A truly professional person will maintain their professional attitude whether they are at work or at home, and thereby uphold the standards and morals of their professionalism in all aspects of their life. A professional will not only be interested in their own personal success, but also in the success of others with whom they are working, their employer and society at large.

Professionalism for an accountant

The International Ethics Standards Board for Accountants (IESBA) is an independent body which sets robust, internationally appropriate ethics standards which all accountants should adhere to. The Code specifies that accountants should follow the guiding principles in relation to integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. It has defined professionalism in terms of professional behaviour, by imposing obligations on accountants to act in the public interest. Therefore, Harry Larsen, as a professional accountant, is bound by the IESBA Code and must accept that he has a broader duty to act in the best interest of others and society as a whole. Consequently, Larsen should take care to avoid any action which could bring discredit to himself or to the accounting profession.

Professionalism as relates to internal audit at Bedruch Co

It is quite clear that Larsen is in a position of power and influence at Bedruch Co because his assessment of the continued viability of the customer relationship management (CRM) system project will ultimately determine whether it proceeds. Therefore, both as a professional accountant and as the leader of the Bedruch internal audit team, he should display the highest standards of professionalism, and submit a report to the audit committee which is factually accurate and based on sound reasoning. This is because the report's recommendations will influence the judgement of the audit committee and directly affect the future performance of Bedruch Co, as well as the immediate employment prospects of his colleagues.

- (b)** Harry Larsen faces the following ethical threats to his independence from the dilemma:

Self-interest threat

This threat to Larsen's independence arises from his close personal relationship with the project manager, as it clearly presents a conflict of interest to him. As the project manager is his girlfriend, he may feel an emotional responsibility towards her and believe that he needs to act primarily in her best interests. So, should the report conclude that the CRM project is no longer

viable, it would be cancelled and his girlfriend would lose her job and she is likely to end her relationship with Harry Larsen, which is clearly not in his personal interest.

Intimidation threat

The intimidation threat also arises from Larsen's relationship, since his girlfriend is apparently pressurising him to misrepresent the viability of the CRM project, if necessary, so that it can continue. However, the inference from the scenario is that the internal audit report is likely to recommend stopping the project because of delays and over-spending, but because of her status in Larsen's life, his girlfriend can exert considerable influence over him. Her power is intensified because no-one in the company is aware of their personal relationship, so would not infer that she could intimidate him.

Familiarity threat

Apart from concerns for his girlfriend's job security, Harry Larsen may be friendly with other colleagues who are also dependent on the CRM project for their continued employment in Bedruch Co. This apparent familiarity could also pose a threat to his independence and objectivity. This could make him inclined to recommend the continuation of the project, even if this is not in the best interests of Bedruch Co and its shareholders.

The threats presented to Harry Larsen will bring into question his professionalism as an accountant bound by a code of ethics. If he opts to recommend continuation of the CRM project for any improper reasons, then his action will bring him into disrepute, cause harm to his employer and its shareholders, and potentially damage the reputation of the accounting profession. Consequently, there are several safeguards which should be put in place to reduce this risk.

Establishing culture

It is the responsibility of the board to inculcate a culture throughout Bedruch Co which encourages a sense of professionalism among all staff. If this becomes the norm, then staff behaviour and actions should always be in the best interest of the company. If Harry Larsen had been immersed in such a professional culture, then the current situation he faces would not have been such an issue to him.

Corporate code of conduct

The most meaningful reason for a corporate code of conduct is to communicate the company's shared purpose and values with its employees and key stakeholders. This should be a values-based approach, providing the tools to support learning and decision making. Bedruch Co could publish a code of conduct which explicitly states what behaviour the company expects from its staff. However, rather than simply prohibiting undesirable actions, such as Harry Larsen offering the wrong recommendation about the CRM project, the code should promote the positive values which form part of the desired culture. To be effective, explicit board-level endorsement of the code is required.

Internal controls

To complement the control environment promoted through the corporate culture, it is essential that certain control procedures are established and operating at Bedruch Co. These will ensure that employees do not act inappropriately with measures in place to actively discourage such behaviours. Internal controls which would have helped to mitigate the threats to independence posed to Harry Larsen could include:

1. Employment contract terms and conditions relating to the disclosure of relationships between members of staff. Such openness would have deterred Larsen's girlfriend from putting pressure on him to save her job, as everyone would know she might be influencing him or he would not be put in a situation where he had to recommend a decision that would affect her future.
 2. Internal audit procedures to prevent and detect fraud and errors. This could involve the head of internal audit independently reviewing the findings of the CRM report and validating the resultant recommendations. This would have removed the likelihood of, and opportunity for, Larsen acting inappropriately.
 3. Proper project management systems, including regular progress reports, would have alerted senior management to the need to take appropriate action early, and removed the requirement for internal audit to intervene.
- (c) The American Accounting Association has developed a seven-step methodology which could be used by Harry Larsen to resolve his ethical dilemma and justify his decision what to do next.

Step 1: What are the facts of the case?

The facts presented are that internal audit has investigated the costs, deliverables and timescales of the CRM project as a basis for determining and recommending to the audit committee on the project's ongoing viability. However, Larsen is under some pressure from his girlfriend to submit a favourable report which will allow the project to complete.

Step 2: What are the ethical issues in the case?

The ethical issue to be considered is whether by failing to make his recommendations purely on the internal audit findings Larsen would not be fulfilling his professional duties. As a professional accountant, Larsen owes a duty to maintain a high level of professionalism in all his actions, and the current situation may compromise this expectation.

Step 3: What are the norms, principles, and values related to the case?

The norms, principles, and values which an internal auditor and professional accountant should follow, in this case Harry Larsen, include impeccable integrity and an assurance of an honest report which does not mislead the audit committee. Other

core principles in the IESBA Code of ethics which relate to the dilemma facing Larsen are his professionalism, objectivity and professional competence and due care, which are brought into question.

Step 4: What are the alternative courses of action?

Larsen has two courses of action which he could adopt. Option 1 is to allow himself to be unduly influenced by his girlfriend and recommend that the CRM project completes, irrespective of the internal audit findings. Option 2 is to make recommendations based purely on the evidence found during the recent internal audit.

Step 5: What is the best course of action which is consistent with the norms, principles, and values identified in Step 3?

The course of action most consistent with the norms, principles, and values of Bedruch Co and the accountancy profession described in Step 3 is Option 2, to make recommendations based purely on the evidence. This action would be honest, objective and taken with due care and consideration to the impact it has on the company and all its stakeholders. Larsen would be displaying his professionalism by ignoring how the impact of the decision would personally affect him or his girlfriend.

Step 6: What are the consequences of each possible course of action?

Under Option 1, Larsen would please his girlfriend and other colleagues whose jobs would be retained, but in doing so could harm Bedruch Co and its wider stakeholder community. He would enjoy a more pleasant personal life but would expose himself to the consequences of his wrongful actions being subsequently revealed.

Under Option 2, several colleagues (including his girlfriend) could lose their jobs at Bedruch Co if the directors decide to cancel the CRM project. However, Larsen would have demonstrated integrity and professionalism.

Step 7: What is the decision?

The only option which is ethically acceptable would be to ignore any external inducements and pressures, and make recommendations based upon the actual findings of the internal audit team, even if this results in his girlfriend losing her job and harming their personal relationship. Therefore, Harry Larsen should select Option 2.

- 4 (a) Risk attitude describes the directors' view on the level of risk which they consider desirable for the company. This can tend towards risk aversion, where risk is only tolerated when there is an acceptable level of return. This is because all businesses must accept a certain amount of risk simply in order to compete, as risk can deliver an upside as well as a downside. However, at the other extreme is the risk seeking business which aims to maximise returns to shareholders irrespective of the amount of risk this takes.

The risk attitude at XSport has been influenced by a range of factors.

Personal views

The most significant influence on XSport's risk attitude appears to come from its powerful and charismatic chief executive officer who appears to dominate the whole board. Christian Harper founded the company, and its success to date can be in part attributed to his entrepreneurial skills. Therefore, it is not surprising that his personal views and attitude towards taking risk have shaped the way business strategy has developed at XSport.

Shareholders' demands

Over time the shareholders at XSport will have decided upon an acceptable risk and return profile, which the board must then deliver. In financial terms, return is a profit on an investment and comprises any change in equity value or dividends which the investor receives from the investment. As Christian Harper is a founding shareholder, who has retained a 40% stake in the business, he is also likely to be highly influential in determining the shareholders' risk and return profile.

Organisation

Risk capacity is the ability an organisation has to take risk, assuming the necessary resources (money, material, men and machinery) are available, since just having a high-risk attitude is not enough. Organisational configuration and resource availability effectively determine a company's capacity to manage the array of risks it faces. At XSport risk capacity has been governed by the low-cost business model it operates and its extensive international retail network structure. Therefore, the risk attitude adopted by the board of XSport will have been influenced by the capacity of the company to deliver its growth strategy.

National

National culture can exert an influence over risk attitude. So, it is probable that the inherent business culture in Laland will have affected the attitudes of all decision-makers in XSport, which will have included their innate risk attitudes. Various dimensions of cultural values in a national culture impact the willingness of entrepreneurial firms, like XSport, to display risk taking, and it is difficult for a business to succeed in its own country if it tries to go against the prevailing national cultural norms.

(b) The dynamic nature of risk assessment

Risks are not static. They change over time and between different situations. One of the key features of any business environment is that the things which affect the performance of an organisation, either internal or external factors, are dynamic. Indeed, the external environment can be turbulent, so it is important to recognise the extent of environmental change when managing risks and devising strategy.

The risks which an organisation faces can change both with internal activities and external environmental changes. New products offered and markets served can also modify the risks faced by an organisation, with some businesses subject to a wide range of domestic and international influences. This means that the assessment of any given risk can change significantly as will the strategy for managing that risk.

Economic risk dynamism

By operating in, and trading with, several countries, XSport exposes itself to risks which emerge from their different economic environments. The policy to import the overwhelming majority of the branded goods it sells in its retail outlets from low-cost economies helps it to be more price competitive for its customers. However, if the relative economic performance of these countries and Laland changes, then any negative movement in exchange rates would cause the cost of importing goods to rise. This will squeeze XSport's margins and reduce its returns to shareholders, which may be unacceptable to them.

The operation of a network of retail outlets in several neighbouring countries also exposes XSport to currency translation risks. The profit generated from these businesses must be translated into the Laland currency for financial reporting purposes, so any change in exchange rate will impact on reported profit and business value.

Clearly the dynamic nature of economic risk creates a problem for XSport's business model, and needs to be effectively responded to, by reviewing XSport's supply network. If exchange rates are volatile, the adoption of a suitable hedging strategy to minimise any downside effects of economic risks will help to improve cash flow management, earnings generated and stabilise the business value.

Political risk dynamism

Political risk is the risk that any political action or event will impact on the position and value of a company. Political changes may result in favourable outcomes to some businesses depending on how it will impact on their operations. However, these risks can also be very damaging if associated with country risk, when they impact on undertaking transactions with, or holding assets in, a particular country.

The outcome of the recent national referendum in Laland to withdraw from the regional customs union will fundamentally change the political relationship between Laland and its neighbouring countries. The uncertainty that this policy change creates could damage business confidence and impact on the domestic Laland economy, at least in the short term. For XSport this may affect domestic demand for its products, which should it fall significantly, will drive down profits. To respond to this risk, the company needs to maintain its flexible and adaptable cost structure.

The imposition of import tariffs on Laland goods to the customs union countries could harm XSport's overseas retail network. The added costs may make the imported produce uncompetitive and drive down sales, which currently accounts for 30% of XSport's reported revenue. To avoid this, the overseas operation must be empowered to continue to negotiate directly with low-cost producers. However, this may still not be sufficient to maintain the financial performance levels currently being attained, so the board of XSport may need to completely change their sales strategy, and even withdraw from the neighbouring countries.

(c) The role of a risk committee

Although corporate governance codes usually do not require that a company establishes a dedicated risk committee, should the board of XSport decide to create such a committee to oversee the company's risk response and management strategies, its role would entail:

1. Raising risk awareness by developing a supportive risk management culture, and setting appropriate policies and a strategy for risk management. Key to this would be to periodically update the company's risk profile, reporting to the board and making recommendations on the risk appetite which the company should adopt to remain successful in its target markets. This is particularly important given the current levels of political and economic uncertainty in Laland.
2. Ensuring that appropriate mechanisms are in place with respect to risk identification, risk assessment, risk assurance and overall risk management throughout the company. This can only be delivered by proper communication of the many risks, policies and controls operating within the company to all employees at all management levels.
3. Confirming that there are adequate training arrangements in place. Staff throughout XSport should be made aware of their responsibilities for risk management. If necessary, the committee should obtain appropriate external advice to ensure that risk management training follows best practice, and is suitable to the dynamically changing environment which the company faces.

To effectively discharge its duties, the risk committee has the following responsibilities:

1. Devising appropriate policies and procedures relating to risk management governance, risk management practices, and developing a risk control infrastructure for the whole company. They will assess the risks arising from any new business ventures, strategic initiatives and environmental influences. At XSport the risk committee would be responsible for a review of financial risk exposure from recent political developments and their economic consequences, and how this may impact on the company's future performance so that appropriate mitigating action can be effected.
2. Making recommendations to the board on all significant matters relating to risk strategy and policies, and providing early warnings of emerging risks and changes to the company's risk exposure. This will include the effective and timely implementation of corrective actions to address risk management deficiencies. They will also consider if the disclosure

of information on internal control, risk management policies and key risk exposures is in accordance with the statutory requirements and financial reporting standards.

3. Monitoring the compliance of the company's risk limiting policies and procedures which relate to risk management governance and control across the whole company. This comprises oversight of the risk management function throughout the company, with responsibility for supervision and monitoring rather than dealing with operational decision making and the implementation of policies.

Corporate governance and risk committees

Corporate governance provides the structure through which corporate objectives are set, and provide a means for achieving those objectives whilst monitoring business performance. Therefore, the establishment of a risk committee comprised entirely of non-executive directors (NEDs) could help to improve the effectiveness of corporate governance arrangements at XSport in the following ways:

1. The formation of a dedicated risk oversight function at board level would reduce the dominance and influence of Christian Harper over all board decision-making. It would ensure that information provided to the board is accurate and derived from systems which are robustly risk managed. This would improve the quality of board level decision-making.
2. It will give more assurance to shareholders that important board duties and responsibilities are being discharged rigorously. By appearing to take risk management seriously, the board will instil more confidence in the providers of capital that their investments are secure and more likely to deliver higher returns. This is particularly important during this period of uncertainty and could decrease the perceived level of risk which the firm faces, which in turn could reduce the costs of raising finance.
3. Separation and detachment from the risk issues under consideration is more likely to deliver independent and objective scrutiny. Any sensitive issues relating to one or more areas of executive director oversight can be discussed openly without vested interests being present, thereby holding the board and its activities to account.
4. NEDs often bring specific expertise in dealing with different economic situations affecting operations which will be more helpful in a risky situation than the more operationally-minded executive directors will have. The NEDs, being from different backgrounds, are likely to bring a range of perspectives and suggested strategies which may increase the options open to the committee when considering specific risks.

- 1** (a) 1 mark each for identifying the control failures giving rise to unethical behaviour
1 mark for analysis of each of the control failures identified (10 marks)
- (b) (i) 1 mark for explanation of each of the risks
1 mark for the impact to HW Bank of failing to manage the risk (6 marks)
- (ii) Up to 2 marks for each point of discussion of how governance could support better internal control and risk management (10 marks)
- (c) Up to 2 marks for explanation of the purpose of a general meeting
Up to 2 marks for each advantage of a general meeting to the shareholders of HW Bank to a maximum of 4 marks (6 marks)
- (d) (i) Up to 2 marks for each explanation of the information the board needs to include in the next external report on internal controls and risk (6 marks)
- (ii) Up to 2 marks for each assessment of the importance of information about operational risks and controls (8 marks)
- Professional marks for format, clarity, logical flow and persuasiveness of the memo. (4 marks)
- (50 marks)**
- 2** (a) Up to 2 marks for each risk identified and assessed
Limit each of the above to 1 mark if not assessed in context to Kramp Telecoms (Max 8 marks)
- (b) Up to 2 marks for each appropriate strategy recommended using the TARA framework
Limit each of the above to 1 mark if not clearly in context to Kramp Telecoms (Max 8 marks)
- (c) Up to 2 marks for each explanation of importance of risk awareness at Kramp up to 5 marks
Up to 2 marks per suggestion on methods of embedding risk awareness at Kramp up to 5 marks
(Max 9 marks)
- (25 marks)**
- 3** (a) Up to 2 marks for a general explanation of professionalism
Up to 6 marks for an explanation of professionalism for an accountant
Up to 2 marks for an explanation of professionalism for internal audit
Limited to one mark if not related to Bedruch Co (Max 8 marks)
- (b) 1 mark for each ethical threat facing Harry Larsen (Max 3 marks)
Up to 2 marks for each safeguard to prevent the ethical situation (Max 6 marks)
Limited to one mark if not situation specific
- (c) 1 mark for each step in the AAA model described to resolve the ethical issue, as applied to the ethical dilemma in the case
2 marks for reaching a decision and making a recommendation (Max 8 marks)
- (25 marks)**

- 4** **(a)** Up to 2 marks for a description of risk attitude at XSport
 Up to 2 marks for each influence on risk attitude at XSport
(Max 6 marks)
- (b)** Up to 2 marks for explanation of risk dynamism
 Up to 4 marks advice with respect to the economic environment
 Up to 4 marks advice with respect to the political environment
 Limit to 1 mark if not specifically related to the Laland and XSport scenario
(Max 9 marks)
- (c)** Up to 3 marks for roles of the risk committee
 Up to 3 marks for responsibilities of the risk committee
 Up to 4 marks corporate governance improvements due to NEDs on risk committee
(Max 10 marks)
- (25 marks)**