

Professional Level – Essentials Module

Governance, Risk and Ethics (Singapore)

September/December 2016 – 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.

Think Ahead

ACCA

The Association of
Chartered Certified
Accountants

Paper P1 (SGP)

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

- 1 Xuland is a developing country. Certain bodies which monitor different governments consider Xuland to have problems with corruption. Xuland authorities are tolerant of breaches in corporate governance compliance among its listed companies. It is common for police officers to request, and receive, corrupt payments from members of society. There is also corruption among public servants, in educational establishments and in many companies.

In the senior levels of business, there is a network of interconnections between business directors and senior members of the government. The prime minister is known to be a reclusive figure and a law prevents the media or public gatherings from voicing any criticism of him or the government. The newspaper media is largely owned and controlled by the government, which means that published criticism of the government is very rarely seen by people in Xuland. Where it is in evidence, the state often takes drastic action to remove such people or to dissuade them from making public criticisms.

Bob Tong is the chief executive of the country's largest business (Xuland Oil). Xuland Oil had been owned by the government until five years ago. It is now listed on the Xuland stock exchange and has secondary listings in other, more developed countries, where the shares have become attractive to investors. This is because Xuland Oil is a monopoly supplier of energy in Xuland and therefore enjoys a home market without competition. Accordingly, it is believed to make strong profits in Xuland. It also exports energy (oil and gas) outside Xuland to neighbouring countries by pipeline, and to other countries by liquefying the gas and shipping it in very large container ships.

Chief executive Bob Tong is believed to receive a substantial fixed salary. However, he also receives 'rewards' from private sector companies for awarding them large support contracts such as for the supply of oil rigs, ships and other important non-current assets. He considers this a way of making money for his retirement. The culture in Xuland means that he is very rarely criticised in public for his behaviour. There is a listing rule about the separation of the roles of CEO and chairman but it is rarely enforced and Mr Tong is also the executive chairman of Xuland Oil. He considers it important that he occupies both roles to prevent his activities from being too closely scrutinised.

Alice Tuesday, a business journalist from outside Xuland, reported that the figure noted in Xuland Oil's remuneration report was clearly not the true figure of what Mr Tang actually received from his leadership of the company. This was because it failed to report the bribes he received from supply contracts.

A major international policy-making body is considering asking all oil and gas companies to produce a stand-alone environmental report each year, reporting in detail on the company's environmental footprint. This is because of a number of recent, high profile cases, in which the poor environmental performance of oil and gas companies has been questioned. A prominent intergovernmental body believes that oil and gas companies will be helping their own reputations by joining the scheme to produce high quality environmental reports each year.

The initiative proposes that each environmental report should contain a meaningful discussion of how each company is attempting to mitigate the worst effects of its environmental impacts. It has been suggested that this report should include figures on all aspects of a company's environmental impacts and also the changes from year-to-year so that stakeholders can monitor how each oil and gas company is performing over the longer term. Some companies, including Xuland Oil, are resisting this initiative, because the board believes that people in Xuland do not care much about the environment. The company's internal audit function has offered to advise on establishing internal controls, in order to assure the company that the information fed into the environmental report has integrity and is accurate.

Xuland Oil has been criticised in international media for acting as an arm of Xuland foreign policy. This has meant, for example, that countries which are not favoured by the Xuland government are charged higher prices for oil imports. Some of the shareholders have been angry about this, as they see their investment as a way of making reliable long-term returns and most shareholders care nothing about Xuland foreign policy. They believe that Xuland Oil should get on with producing returns and ignore the pressure by the Xuland government to be a part of Xuland foreign policy. The pressure for Mr Tong and the company board to enact foreign policy is thought to be linked to the intimate relations among the elites in Xuland society. Many government ministers and senior business figures went to the same universities and remain close friends outside their working lives.

The journalist, Alice Tuesday, has been investigating the problems at Xuland Oil for some years and has widely reported the corruption in Xuland society. She pointed out that many of the jobs in the Xuland public sector tended to be concentrated among one of the several ethnic groups in Xuland and this, she believed, was anti-meritocratic and did not serve the country's best interests. It was she who exposed Mr Tong for taking bribes on supply contracts. She has also recently accused the prime minister of taking money from public accounts for his own use. She said that

Xuland Oil needs to decide if it is a business organisation or a part of the Xuland state, and to notify its shareholders accordingly. Mr Tong is a close personal friend of the prime minister and other senior government ministers. He is also a strong supporter of the government and its policies.

Alice Tuesday's view is that Xuland is structurally corrupt and needs a thorough review of its culture. As a developing country, Alice Tuesday says that it will not become a developed country until it tackles its problem with corruption, including corruption in the police and in the public services. She recently wrote that, 'if Xuland tolerates corruption, it is choosing poverty over development, and this a terrible shame for the decent, hard-working families in Xuland, who deserve a better future. Xuland has been appallingly-led for many years, and the ruling class has badly let down the people of Xuland.'

Required:

- (a) **Explain why, in the case of Xuland Oil, the shareholders would benefit if the roles of chief executive and chairman were split and an effective non-executive chairman was appointed.** (8 marks)
- (b) The bribes which Mr Tong accepted means that the remuneration report does not contain a complete picture of his annual income.

Required:

- (i) **Discuss the importance of completeness in a remuneration report and explain how the inaccuracy of information on the remuneration of executive directors creates a potential agency problem.** (8 marks)
- (ii) **Explain why most shareholders would support a link between rewards and performance, and why this link is important to shareholders.** (6 marks)
- (c) Xuland Oil's overseas investors have encouraged the company to adopt the compulsory environmental reporting in order to ensure that all environmental risks are considered.

Required:

Explain the importance of effective internal controls and internal audit in underpinning the proposed compulsory environmental reporting requirement. (8 marks)

- (d) Alice Tuesday intends to write an article for international media to discuss several important issues with the governance of Xuland Oil. Draft this article, to include the following content.

Required:

- (i) **Explain the meaning of 'corruption' and discuss the barriers to improving the corrupt practices in Xuland.** (8 marks)
- (ii) **Propose measures which might be put in place to defeat corruption in Xuland.** (8 marks)

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

(50 marks)

Section B – TWO questions ONLY to be attempted

- 2 Stefan Krank had been the most successful fund manager at Fortune Investments for the past five years. During this time he had earned a large salary, which was supplemented by considerable annual bonuses from the many profitable investment portfolios he had managed for his wealthy private clients. Consequently, he and his family had become accustomed to a very lavish lifestyle, which was threatened when he started to have a run of bad luck on the markets.

Over the past few months he had been unable to deliver the predicted levels of returns for his clients, so he decided to resort to drastic measures. Initially he tried to recover the position by investing funds in high risk securities to generate higher returns, even though his clients had only ever agreed to medium risk levels for their investments. However, even this tactic failed to deliver sufficient profits and some investments actually lost considerable amounts of money. In desperation Krank's behaviour took a very disturbing turn when he started a fraudulent investment operation where he paid returns to his existing investors from new capital paid into the fund by new investors, rather than from profit earned. He enticed new investors into the scheme by offering them far higher returns than were available from other comparable investments, often in the form of short-term profits which were both abnormally high and unusually consistent. Unfortunately in order to maintain this deception of seemingly perpetual high returns, Krank required an ever-increasing flow of money from new investors which was clearly unsustainable. Over time returns became far more volatile simply because of the higher risk investments and reduced amounts of new investment capital becoming available.

James Reynolds, a wealthy client who wanted to extract value from a fund managed by Krank for his impending retirement, noticed that returns on his fund were showing increased volatility. He demanded an explanation from Krank, who responded by advising him that he must have looked at his fund on a bad day. He assured Mr Reynolds he always aimed to maximise returns on his clients' investments even if this meant bending the rules occasionally. He further claimed that Mr Reynold's fund would both grow in value and stabilise very soon. Mr Reynolds was unconvinced by Krank's weak and unsubstantiated explanation; so he referred the matter to Krank's manager.

Required:

- (a) **Discuss the extent to which the main objectives of an internal control system were not achieved at Fortune Investments, and criticise how the behaviour of Stefan Krank resulted in a clear breach in his duty to his clients as their fund manager.** (12 marks)
- (b) **Explain the importance of good quality information both for the effective management of funds, and their monitoring by investors.** (7 marks)

Stefan Krank had told Mr Reynolds that 'he always aimed to maximise returns on his clients' investments even if this meant bending the rules occasionally' to achieve this.

Required:

- (c) **Explain ethical relativism, and examine how Stefan Krank cannot justify his actions using relativist arguments.** (6 marks)

(25 marks)

- 3** Recent changes to environmental regulations have shifted the onus of responsibility onto companies to prove that their actions did not cause environmental harm, rather than requiring the regulators to prove where fault lies. The board of Oskal Petroleum decided to review its strategic position and how this regulatory change could impact on Oskal Petroleum. The directors concluded that the new regulations potentially exposed their business to considerable costs if they were required to deal with the aftermath of a spillage of any environmentally hazardous substance, such as oil. These costs would be above and beyond any fines or compensation orders which might flow from a related prosecution.

A major spillage from a competitor's oil rig off the African coast several years ago is still under investigation and so far it has resulted in hundreds of millions in related costs, which damaged the business significantly and caused a large and sustained drop in the share price.

Oskal Petroleum, although based in Europe, is a global business with onshore and offshore oil fields in four continents. It has always enjoyed good relations with the host governments in those countries where it has operations, but recently several governments have adopted a more interventionist approach to domestic environmental policy in the aftermath of the African oil disaster. Consequently, the finance director strongly advised the board to set aside an amount of cash equal to 10% of profits, to mitigate against the impact of any costs which might arise if an Oskal oil field suffered a major spillage. The finance director's proposal was approved alongside the decision to undertake a formal environmental risk assessment of all Oskal operational assets throughout the world, particularly in those countries where governments were taking a keen interest in influencing the environmental and social policies of businesses.

In a further attempt to pacify its active stakeholders, and show shareholders that they were taking environmental risks seriously, the board decided to fully adopt the integrated reporting framework. It planned to include the findings from the environmental risk assessment in the next annual report.

Required:

- (a) **Describe environmental risk, and evaluate the sources of environmental risk which are likely to be identified during Oskal's forthcoming assessment, and suggest ways the company could reduce their impact.** (9 marks)
- (b) **Describe a framework which could be utilised by the board of Oskal for the management of risk.** (8 marks)
- (c) **Explain the concept of integrated reporting <IR>, and explore how an integrated report covering the six capitals provides insights for the shareholders and other stakeholders of Oskal Petroleum.** (8 marks)

(25 marks)

- 4 John Mathers, a qualified accountant and the finance director of the international construction company Parkstone, was recently jailed for 18 months as a result of being convicted of insider trading. Mathers profited from dealing in his company's shares around the time that a \$50m government contract was awarded for the construction of 2,000 new social houses, which sent Parkstone's share price soaring in value.

Using a false name to avoid being detected, Mathers bought 100,000 Parkstone shares in small batches regularly during the three-month period before the lucrative deal was finalised, when the price was settled at around \$5.40. He sold all of the shares the day after the government-financed building contract was announced when the share price had risen by 22%, thereby making a clear profit of around \$120,000.

Mathers was jailed because he used his inside knowledge at Parkstone to personally profit, abusing his senior position in the company because he was privy to all the negotiations leading up to the deal. The judge at his trial acknowledged that Mathers had shown genuine remorse for his crime, but the offence was so serious that it warranted a custodial sentence. He said that Mathers used his position as finance director to unlawfully profit from information about the forthcoming contract, and had shown a clear breach of the trust placed in him. He had been motivated by personal greed and knew at the time that his actions were illegal. The judge told him that insider trading was not a victimless crime, and his actions had had a very negative impact on overall public confidence in the integrity of the market.

A spokesman for Parkstone said that they were reassured that an independent investigation into the company's financial conduct surrounding the insider trading incident did not raise any wider governance concerns. He insisted that despite the gross misconduct of one of its directors, the company's internal controls were sufficiently robust to provide the information necessary for the authorities to achieve a successful prosecution of Mathers. It was also acknowledged that because Parkstone had won a building contract for the public sector, it would need to demonstrate that it was delivering value for money throughout the duration of the contract.

Required:

- (a) **Describe insider trading and how it can compromise directors' corporate responsibilities, and explain how the actions of John Mathers could have undermined general confidence in the stock market.** (8 marks)
- (b) **Discuss how John Mathers' behaviour was a clear breach of the IESBA [IFAC] code of ethics which, as a professional accountant, he should have strictly followed.** (10 marks)
- (c) **Explain how Parkstone has a corporate social responsibility to act in the public interest because of the publicly funded building contract awarded, and evaluate how they are able to demonstrate that they are delivering value for money.** (7 marks)

(25 marks)

End of Question Paper