

Professional Level – Essentials Module

Governance, Risk and Ethics (Singapore)

Wednesday 20 June 2012



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

The Institute of Certified Public Accountants of Singapore

ACCA



Paper P1 (SGP)

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

- 1 Hayho is a large international company with direct investments in 65 countries. It is a manufacturer of high technology products, with each Hayho factory typically employing over 3,000 people. Hayho factories also support local supply chains employing many more people so each Hayho plant is considered a vital part of the regional economy in which it is located.

Several years ago, Hayho was widely criticised for its operations in Arrland, a developing country with an oppressive and undemocratic government. Investigative journalists produced material showing the poor conditions of workers, and pollution around the Hayho factories in Arrland. They also showed evidence suggesting that Hayho had paid bribes to the Arrland government so that local opposition to the Hayho operation could be forcefully stopped. After this episode, the company became very sensitive to criticism of its operations in developing countries. A press statement at the time said that Hayho, in future, would always uphold the highest standards of integrity, human rights and environmental protection whilst at the same time 'responsibly' supporting developing countries by providing jobs and opportunities to enable greater social and economic development.

The board of Hayho is now deciding between two possible large new investments, both directly employing about 3,000 people. Both options have a number of advantages and disadvantages and Mr Woo, Hayho's finance director, has recently made clear that only one can be chosen at this stage. The two options are of similar investment value and are referred to as the 'Jayland option' and the 'Pealand option'.

The 'Jayland option' is to build a new large factory in Jayland and to recruit a completely new local workforce to work in it. Jayland is a developing country with few environmental and labour regulations. It has a poorly developed education and training system, and is generally considered to be undemocratic. Its president, Mr Popo, has been in office since he seized power in a military coup 30 years ago. Human rights organisations say that he maintains order by abusing the rights of the people and cruelly suppressing any dissent against him. In early exploratory talks between Hayho and the Jayland government, Hayho was given assurances that it could pursue its activities with little regulation from the government as long as the Jayland president, Mr Popo, received a personal annual 'royalty' (effectively a bribe) for allowing Hayho to operate in his country.

Finance director Mr Woo said that some stakeholders would probably criticise Hayho, perhaps in the international media, for investing in Jayland. Hayho may be accused of supporting the dictatorship of Mr Popo in that country, especially if the 'royalty' was ever discovered. Mr Woo calculated that the NPV (net present value) of projected pre-tax returns of the Jayland option over a ten-year period was \$2 billion but that there was also a risk of potential political instability in Jayland during the lifetime of the investment.

The 'Pealand option' is to buy an existing plant in Pealand which would then be refurbished to facilitate the manufacture of Hayho products. This would involve 'inheriting' the workforce of the previous owners. Pealand is a 'new democracy', and a transitional economy, having gained its independence ten years ago. In an attempt to purge the corrupt business practices associated with its past, the Pealand government has become very thorough in ensuring that all inward investments, including Hayho's factory purchase, meet exacting and demanding standards of environmental protection and work conditions. Mr Woo, the finance director, said that the NPV of projected pre-tax returns over a ten-year period was \$1 billion for the Pealand option but that the risk of political instability in Pealand was negligible. Both of the returns, the forecast \$2 billion for Jayland and the \$1 billion for Pealand, were considered to be acceptable in principle.

Mr Woo also said that there were issues with the two options relating to the effectiveness of necessary internal controls. Whichever option was chosen (Jayland or Pealand), it would be necessary to establish internal controls to enable accurate and timely reporting of production and cost data back to head office. So a number of systems would need to be put in place to support the production itself. One staff member, Emily Baa, who had previously worked in Jayland for another company, gave her opinion to the board about some of the issues that Hayho might encounter if it chose the Jayland option. She said that Jayland was very under developed until relatively recently and explained how the national culture was unfamiliar with modern business practice and behaviour. She said that property security may be a problem and that there was a potential risk to assets there. She also said that, in her opinion, there was a lack of some key job skills among the potential workforce in Jayland such as quality control and accounting skills. She explained that quality control skills would be necessary to ensure product specifications were met and that accounting skills would be necessary for the provision of internal and external reporting. As a manufacturer of very technologically advanced products, a number of stringent international product standards applied to Hayho products wherever in the world they were produced.

Meanwhile, news that Hayho was considering a large investment in Jayland leaked out to the press. In response, Hayho's chief executive, Helen Duomo received two letters. The first was from a prominent international human rights lobbying organisation called 'Watching Business' (WB). In the letter, the lobby group said that because of its 'terrible track record' in Arland and elsewhere, Hayho was being carefully monitored for its 'unethical business practices'. WB said its interest in Hayho's activities had been rekindled since it had received intelligence about the possible investment in Jayland and warned Mrs Duomo not to make the investment because it would provide credibility for the 'brutal dictatorship' of Mr Popo.

Whilst Mrs Duomo, known for her forthright manner, would normally dismiss threats from groups of this type, she knew that WB had a lot of support among senior politicians and legislators in many parts of the world. She believed that WB could achieve some power by mobilising public opinion through effective use of mass media, such as newspapers and television. WB was also respected as a research organisation and its advice was often sought by politicians and trade organisations.

Mrs Duomo said she was frustrated whenever anybody got in the way of her accountability to the Hayho shareholders, but that some interests could not be ignored because of their potential to influence. WB fell into this category.

The second letter she received was from the head of Quark Investments, Hayho's single biggest institutional shareholder. The letter sought to remind Mrs Duomo that the Hayho board was employed by its shareholders and that Mrs Duomo should be determined and resolute in maximising shareholder returns. The letter encouraged the board not to be diverted by 'well meaning but misinformed outsiders concerned with things that were actually none of their business'.

Aware that she had to manage two competing demands placed on her, Mrs Duomo sought advice from Emily Baa, who had experience of life in Jayland. So she asked Emily Baa to prepare some notes for the next board meeting to clarify whom the board of Hayho was actually accountable to and how it might respond to the letter from WB.

Required:

- (a) Explain 'risk appetite' and demonstrate how different risk appetites might affect the selection of investments between Jayland and Pealand.** (6 marks)
- (b) Use the AAA (American Accounting Association) seven-step model to examine the ethical decision whether to select the Jayland option or the Pealand option.** (14 marks)
- (c) Describe the general purposes of an internal control system and, based on Emily Baa's views, assess the main internal control challenges that Hayho might encounter if it chose the Jayland option.** (12 marks)
- (d) Prepare briefing notes from Emily Baa to prepare the chief executive of Hayho, Helen Duomo, for the board meeting as requested in the case. The notes should cover the following:**
 - (i) A discussion of the meaning of accountability at Hayho and of how the Mendelow framework can be used to predict the influence of the Watching Business pressure group;** (7 marks)
 - (ii) A brief explanation of the agency relationship between the board of Hayho and Quark Investments, and advice on why the demands from Watching Business should be carefully considered.** (7 marks)

Professional marks will be awarded in part (d) for the clarity, flow, persuasiveness and structure of the briefing notes. (4 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

- 2 John Louse, the recently retired chief executive of Zogs Company, a major listed company, was giving a speech reflecting on his career and some of the aspects of governance he supported and others of which he was critical. In particular, he believed that board committees were mainly ineffective. A lot of the ineffectiveness, he said, was due to the lack of independence of many non-executive directors (NEDs). He believed that it was not enough just to have the required number of non-executive directors; they must also be 'truly independent' of the executive board. It was his opinion that it was not enough to have no material financial connection with a company for independence: he believed that in order to be truly independent, NEDs should come from outside the industry and have no previous contact with any of the current executive directors.

In relation to risk committees, he said that in his experience, the company's risk committee had never stopped any risk affecting the company and because of this, he questioned its value. He said that the risk committee was 'always asking for more information, which was inconvenient' and had such a 'gloomy and pessimistic' approach to its task. He asked, 'why can't risk committees just get on with stopping risk, and also stop making inconvenient demands on company management? Do they think middle managers have nothing else to do?' He viewed all material risks as external risks and so the risk committee should be looking outwards and not inwards.

Since retiring from Zogs, Mr Louse had taken up a non-executive directorship of SmallCo, a smaller private company in his town. In a meeting with Alan Ng, the new chief executive of Zogs, Mr Ng said that whilst risk management systems were vital in large companies like Zogs, fewer risk controls were needed in smaller companies like SmallCo.

Required:

- (a) **Define 'independence' in the context of corporate governance and critically evaluate Mr Louse's comment that greater independence of non-executive directors is important in increasing the effectiveness of board committees.** (8 marks)
- (b) **Describe the roles of a risk committee and criticise Mr Louse's understanding of the risk committee in Zogs Company.** (9 marks)
- (c) **Assess whether risk committees and risk mitigation systems are more important in larger companies, like Zogs, than in smaller companies like SmallCo.** (8 marks)

(25 marks)

- 3** Jojo Auditors is an audit practice with five partners. The five partners have worked together for several years and, as well as being work colleagues, are personal friends with each other. At Jojo it is customary for the performance of all student accountants to be appraised after their first year of a training contract using a range of criteria including examination success, technical ability and professionalism. Three levels of outcome are possible:

1. 'Good', allowing students to continue with no issues;
2. 'Some concerns', meaning students are counselled and then allowed to continue; and,
3. 'Poor', where students are dismissed from the audit practice.

The appraisal committee is comprised of three people: managing partner Jack Hu, the training manager (both of whom are professional accountants) and the person responsible for human resources. The committee receives confidential reports on each student and makes decisions based on the views of relevant engagement partners and also exam results. It is normally the training manager who makes the recommendation and in most cases his appraisal is agreed and then acted upon accordingly. Because the appraisals are confidential between the student and the firm, the list of students and their appraisal categories are not publicised within the firm.

When the 2010 intake was being appraised last year, one student was appraised by the training manager as 'poor' but was not dismissed. Polly Shah was unpopular among other students because she was considered lazy and technically weak. She also failed a number of her exams. Other students who were appraised as 'poor' were dismissed, but Polly received a brief counselling session from Jack Hu and then returned to her duties. Polly stayed for another year and then, having failed more exams, left Jojo to pursue other career interests outside accounting.

Polly's departure triggered some discussion amongst Jojo's partners as to why she had been retained when other poor performers had not. It later emerged that Jack Hu was a close friend of Polly's parents and had enjoyed free holidays in the Shah family's villa for several years. Because he was the managing partner, Mr Hu was able to insist on retaining Polly, despite the objections of the training manager and the human resources representative, although the training manager was reported to be furious at the decision to retain Polly.

Required:

- (a) Define 'conflict of interest' and assess the consequences of Jack Hu's behaviour after Polly Shah's appraisal.**
(10 marks)
- (b) Describe four ethical safeguards that could be used in Jojo to prevent a recurrence of the events like those described in the case.**
(8 marks)
- (c) The case raises issues of the importance of senior management performance measurement. In a public company, this refers to directors, and in a privately-owned partnership like Jojo, it refers to partners. The managing partner (Mr Hu's position) is equivalent to the role of chief executive.**

Required:

Explain the typical criteria used in the performance measurement of individual directors and discuss the reasons why individual performance measurement of partners may be difficult to implement at Jojo.

(7 marks)

(25 marks)

- 4 Lum Co is a family business that has been wholly-owned and controlled by the Lum family since 1920. The current chief executive, Mr Gustav Lum, is the great grandson of the company's founder and has himself been in post as CEO since 1998. Because the Lum family wanted to maintain a high degree of control, they operated a two-tier board structure: four members of the Lum family comprised the supervisory board and the other eight non-family directors comprised the operating board.

Despite being quite a large company with 5,000 employees, Lum Co never had any non-executive directors because they were not required in privately-owned companies in the country in which Lum Co was situated.

The four members of the Lum family valued the control of the supervisory board to ensure that the full Lum family's wishes (being the only shareholders) were carried out. This also enabled decisions to be made quickly, without the need to take everything before a meeting of the full board.

Starting in 2008, the two tiers of the board met in joint sessions to discuss a flotation (issuing public shares on the stock market) of 80% of the company. The issue of the family losing control was raised by the CEO's brother, Mr Crispin Lum. He said that if the company became listed, the Lum family would lose the freedom to manage the company as they wished, including supporting their own long-held values and beliefs. These values, he said, were managing for the long term and adopting a paternalistic management style. Other directors said that the new listing rules that would apply to the board, including compliance with the stock market's corporate governance codes of practice, would be expensive and difficult to introduce.

The flotation went ahead in 2011. In order to comply with the new listing rules, Lum Co took on a number of non-executive directors (NEDs) and formed a unitary board. A number of problems arose around this time with NEDs feeling frustrated at the culture and management style in Lum Co, whilst the Lum family members found it difficult to make the transition to managing a public company with a unitary board. Gustav Lum said that it was very different from managing the company when it was privately owned by the Lum family. The human resources manager said that an effective induction programme for NEDs and some relevant continuing professional development (CPD) for existing executives might help to address the problems.

Required:

- (a) **Compare the typical governance arrangements between a family business and a listed company, and assess Crispin's view that the Lum family will 'lose the freedom to manage the company as they wish' after the flotation.** (10 marks)
- (b) **Assess the benefits of introducing an induction programme for the new NEDs, and requiring continual professional development (CPD) for the existing executives at Lum Co after its flotation.** (8 marks)
- (c) **Distinguish between unitary and two-tier boards, and discuss the difficulties that the Lum family might encounter when introducing a unitary board.** (7 marks)

(25 marks)

End of Question Paper