Professional Level – Essentials Module

Professional Accountant

Monday 8 December 2008

Paper P1

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

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

1 The scientists in the research laboratories of Swan Hill Company (SHC, a public listed company) recently made a very important discovery about the process that manufactured its major product. The scientific director, Dr Sonja Rainbow, informed the board that the breakthrough was called the 'sink method'. She explained that the sink method would enable SHC to produce its major product at a lower unit cost and in much higher volumes than the current process. It would also produce lower unit environmental emissions and would substantially improve product quality compared to its current process and indeed compared to all of the other competitors in the industry.

SHC currently has 30% of the global market with its nearest competitor having 25% and the other twelve producers sharing the remainder. The company, based in the town of Swan Hill, has a paternalistic management approach and has always valued its relationship with the local community. Its website says that SHC has always sought to maximise the benefit to the workforce and community in all of its business decisions and feels a great sense of loyalty to the Swan Hill locality which is where it started in 1900 and has been based ever since.

As the board considered the implications of the discovery of the sink method, chief executive Nelson Cobar asked whether Sonja Rainbow was certain that SHC was the only company in the industry that had made the discovery and she said that she was. She also said that she was certain that the competitors were 'some years' behind SHC in their research.

It quickly became clear that the discovery of the sink method was so important and far reaching that it had the potential to give SHC an unassailable competitive advantage in its industry. Chief executive Nelson Cobar told board colleagues that they should clearly understand that the discovery had the potential to put all of SHC's competitors out of business and make SHC the single global supplier. He said that as the board considered the options, members should bear in mind the seriousness of the implications upon the rest of the industry.

Mr Cobar said there were two strategic options. Option one was to press ahead with the huge investment of new plant necessary to introduce the sink method into the factory whilst, as far as possible, keeping the nature of the sink technology secret from competitors (the 'secrecy option'). A patent disclosing the nature of the technology would not be filed so as to keep the technology secret within SHC. Option two was to file a patent and then offer the use of the discovery to competitors under a licensing arrangement where SHC would receive substantial royalties for the twenty-year legal lifetime of the patent (the 'licensing option'). This would also involve new investment but at a slower pace in line with competitors. The licence contract would, Mr Cobar explained, include an 'improvement sharing' requirement where licensees would be required to inform SHC of any improvements discovered that made the sink method more efficient or effective.

The sales director, Edwin Kiama, argued strongly in favour of the secrecy option. He said that the board owed it to SHC's shareholders to take the option that would maximise shareholder value. He argued that business strategy was all about gaining competitive advantage and this was a chance to do exactly that. Accordingly, he argued, the sink method should not be licensed to competitors and should be pursued as fast as possible. The operations director said that to gain the full benefits of the sink method with either option would require a complete refitting of the factory and the largest capital investment that SHC had ever undertaken.

The financial director, Sean Nyngan, advised the board that pressing ahead with investment under the secrecy option was not without risks. First, he said, he would have to finance the investment, probably initially through debt, and second, there were risks associated with any large investment. He also informed the board that the licensing option would, over many years, involve the inflow of 'massive' funds in royalty payments from competitors using the SHC's patented sink method. By pursuing the licensing option, Sean Nyngan said that they could retain their market leadership in the short term without incurring risk, whilst increasing their industry dominance in the future through careful investment of the royalty payments.

The non-executive chairman, Alison Manilla, said that she was looking at the issue from an ethical perspective. She asked whether SHC had the right, even if it had the ability, to put competitors out of business.

Required:

(a) **Assess the secrecy option using Tucker's model for decision-making.** (10 marks)

(b) **Distinguish between strategic and operational risks, and explain why the secrecy option would be a source of strategic risk.** (10 marks)

(c) Mr Cobar, the chief executive of SHC, has decided to draft two alternative statements to explain both possible outcomes of the secrecy/licensing decision to shareholders. Once the board has decided which one to pursue, the relevant draft will be included in a voluntary section of the next corporate annual report.

Required:

(i) **Draft a statement in the event that the board chooses the secrecy option. It should make a convincing business case and put forward ethical arguments for the secrecy option. The ethical arguments should be made from the stockholder (or pristine capitalist) perspective.** (8 marks)

(ii) **Draft a statement in the event that the board chooses the licensing option. It should make a convincing business case and put forward ethical arguments for the licensing option. The ethical arguments should be made from the wider stakeholder perspective.** (8 marks)

(iii) **Professional marks for the persuasiveness and logical flow of arguments: two marks per statement.** (4 marks)

(d) Corporate annual reports contain both mandatory and voluntary disclosures.

Required:

(i) **Distinguish, using examples, between mandatory and voluntary disclosures in the annual reports of public listed companies.** (6 marks)

(ii) **Explain why the disclosure of voluntary information in annual reports can enhance the company's accountability to equity investors.** (4 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 Chen Products produces four manufactured products: Products 1, 2, 3 and 4. The company's risk committee recently met to discuss how the company might respond to a number of problems that have arisen with Product 2. After a number of incidents in which Product 2 had failed whilst being used by customers, Chen Products had been presented with compensation claims from customers injured and inconvenienced by the product failure. It was decided that the risk committee should meet to discuss the options.

When the discussion of Product 2 began, committee chairman Anne Ricardo reminded her colleagues that, apart from the compensation claims, Product 2 was a highly profitable product.

Chen's risk management committee comprised four non-executive directors who each had different backgrounds and areas of expertise. None of them had direct experience of Chen's industry or products. It was noted that it was common for them to disagree among themselves as to how risks should be managed and that in some situations, each member proposed a quite different strategy to manage a given risk. This was the case when they discussed which risk management strategy to adopt with regard to Product 2.

Required:

(a) Describe the typical roles of a risk management committee. (6 marks)

(b) Using the TARA framework, construct four possible strategies for managing the risk presented by Product 2. Your answer should describe each strategy and explain how each might be applied in the case. (10 marks)

(c) Risk committee members can be either executive or non-executive.

Required:

(i) Distinguish between executive and non-executive directors. (2 marks)

(ii) Evaluate the relative advantages and disadvantages of Chen's risk management committee being non-executive rather than executive in nature. (7 marks)

(25 marks)

3 Susan Paullaos was recently appointed as a non-executive member of the internal audit committee of Gluck and Goodman, a public listed company producing complex engineering products. Barney Chester, the executive finance director who chairs the committee, has always viewed the purpose of internal audit as primarily financial in nature and as long as financial controls are seen to be fully in place, he is less concerned with other aspects of internal control. When Susan asked about operational controls in the production facility Barney said that these were not the concern of the internal audit committee. This, he said, was because as long as the accounting systems and financial controls were fully functional, all other systems may be assumed to be working correctly.

Susan, however, was concerned with the operational and quality controls in the production facility. She spoke to production director Aaron Hardanger, and asked if he would be prepared to produce regular reports for the internal audit committee on levels of specification compliance and other control issues. Mr Hardanger said that the internal audit committee had always trusted him because his reputation as a manager was very good. He said that he had never been asked to provide compliance evidence to the internal audit committee and saw no reason as to why he should start doing so now.

At board level, the non-executive chairman, George Allejandra, said that he only instituted the internal audit committee in the first place in order to be seen to be in compliance with the stock market's requirement that Gluck and Goodman should have one. He believed that internal audit committees didn't add materially to the company. They were, he believed, one of those 'outrageous demands' that regulatory authorities made without considering the consequences in smaller companies nor the individual needs of different companies. He also complained about the need to have an internal auditor. He said that Gluck and Goodman used to have a full time internal auditor but when he left a year ago, he wasn't replaced. The audit committee didn't feel it needed an internal auditor because Barney Chester believed that only financial control information was important and he could get that information from his management accountant.

Susan asked Mr Allejandra if he recognised that the company was exposing itself to increased market risks by failing to have an effective audit committee. Mr Allejandra said he didn't know what a market risk was.

Required:

(a) Internal control and audit are considered to be important parts of sound corporate governance.

(i) Describe FIVE general objectives of internal control. (5 marks)

(ii) Explain the organisational factors that determine the need for internal audit in public listed companies. (5 marks)

(b) Criticise the internal control and internal audit arrangements at Gluck and Goodman as described in the case scenario. (10 marks)

(c) Define 'market risk' for Mr Allejandra and explain why Gluck and Goodman's market risk exposure is increased by failing to have an effective audit committee. (5 marks)

(25 marks)

4 Hogg Products Company (HPC), based in a developing country, was recently wholly acquired by American Overseas Investments (AOI), a North American holding company. The new owners took the opportunity to completely review HPC's management, culture and systems. One of the first things that AOI questioned was HPC's longstanding corporate code of ethics.

The board of AOI said that it had a general code of ethics that HPC, as an AOI subsidiary, should adopt. Simon Hogg, the chief executive of HPC, disagreed however, and explained why HPC should retain its existing code. He said that HPC had adopted its code of ethics in its home country which was often criticised for its unethical business behaviour. Some other companies in the country were criticised for their 'sweat shop' conditions. HPC's adoption of its code of ethics, however, meant that it could always obtain orders from European customers on the guarantee that products were made ethically and in compliance with its own highly regarded code of ethics. Mr Hogg explained that HPC had an outstanding ethical reputation both locally and internationally and that reputation could be threatened if it was forced to replace its existing code of ethics with AOI's more general code.

When Ed Tanner, a senior director from AOI's head office, visited Mr Hogg after the acquisition, he was shown HPC's operation in action. Mr Hogg pointed out that unlike some other employers in the industry, HPC didn't employ child labour. Mr Hogg explained that although it was allowed by law in the country, it was forbidden by HPC's code of ethics. Mr Hogg also explained that in his view, employing child labour was always ethically wrong. Mr Tanner asked whether the money that children earned by working in the relatively safe conditions at HPC was an important source of income for their families. Mr Hogg said that the money was important to them but even so, it was still wrong to employ children, as it was exploitative and interfered with their education. He also said that it would alienate the European customers who bought from HPC partly on the basis of the terms of its code of ethics.

Required:

(a) **Describe the purposes and typical contents of a corporate code of ethics.** (9 marks)

(b) 'Strategic positioning' is about the way that a company as a whole is placed in its environment and concerns its 'fit' with the factors in its environment.

With reference to the case as appropriate, explain how a code of ethics can be used as part of a company's overall strategic positioning. (7 marks)

(c) **Assess Mr Hogg's belief that employing child labour is 'always ethically wrong' from deontological and teleological (consequentialist) ethical perspectives.** (9 marks)

(25 marks)

End of Question Paper