In this supplementary Section B pilot paper there are three 25-mark questions, with answers and marking schemes.

Note that to answer each 25-mark question would require 45 minutes of standard writing time plus three minutes of standard reading and planning time.
The board of JH Graphics, a design and artwork company, was debating an agenda item on the possible adoption of a corporate code of ethics. Jenny Harris, the chief executive and majority shareholder, was a leading supporter of the idea. She said that many of the large companies in the industry had adopted codes of ethics and that she thought it would signal the importance that JH Graphics placed on ethics. She also said that she was personally driven by high ethical values and that she wanted to express these through her work and through the company's activities and policies.

Alan Leroy, the creative director, explained that he would support the adoption of the code of ethics as long as it helped to support the company's long-term strategic objectives. He said that he could see no other reason as the company was 'not a charity' and had to maximise shareholder value above all other objectives. In particular, he was keen, as a shareholder himself, to know what the code would cost to draw up and how much it would cost to comply with it over and above existing costs.

Jenny argued that having a code would help to resolve some ethical issues, one of which, she suggested, was a problem the company was having over a particular image it had recently produced for a newspaper advertisement. The image was produced for an advertising client and although the client was pleased, it had offended a particular religious group because of its content and design.

When it was discovered who had produced the 'offending' image, some religious leaders criticised JH Graphics for being insensitive and offensive to their religion. For a brief time, the events were a major news story. As politicians, journalists and others debated the issues in the media, the board of JH Graphics was involved in intense discussions and faced with a dilemma as to whether or not to issue a public apology for the offence caused by the image and to ask the client to withdraw it.

Alan argued that having a code of ethics would not have helped in that situation, as the issue was so complicated. His view was that the company should not apologise for the image and that he didn't care very much that the image offended people. He said it was bringing the company free publicity and that was good for the business. Jenny said that she had sympathy for the viewpoint of the offended religious leaders. Although she disagreed with them, she understood the importance to some people of firmly-held beliefs. The board agreed that as there seemed to be arguments both ways, the decision on how the company should deal with the image should be Jenny's as chief executive.

Required:

(a) Analyse Jenny's and Alan's motivations for adopting the code of ethics using the normative-instrumental forms of stakeholder theory. (8 marks)

(b) Assess Jenny's decision on the possible apology for the 'offending' image from conventional and pre-conventional moral development perspectives. (4 marks)

(c) Explain and assess the factors that the board of JH Graphics might consider in deciding how to respond to the controversy over the offending image. (10 marks)

(d) Comment on the legitimacy of the religious group's claims on JH Graphics's activities. (3 marks)

(25 marks)
The board of Franks & Fisher, a large manufacturing company, decided to set up an internal control and audit function. The proposal was to appoint an internal auditor at mid-management level and also to establish a board level internal audit committee made up mainly of non-executive directors.

The initiative to do so was driven by a recent period of rapid growth. The company had taken on many more activities as a result of growth in its product range. The board decided that the increased size and complexity of its operations created the need for greater control over internal activities and that an internal audit function was a good way forward. The need was highlighted by a recent event where internal quality standards were not enforced, resulting in the stoppage of a production line for several hours. The production director angrily described the stoppage as ‘entirely avoidable’ and the finance director, Jason Kumas, said that the stoppage had been very costly.

Mr Kumas said that there were problems with internal control in a number of areas of the company’s operations and that there was a great need for internal audit. He said that as the head of the company’s accounting and finance function, the new internal auditor should report to him. The reasons for this, he said, were because as an accountant, he was already familiar with auditing procedure and the fact that he already had information on budgets and other ‘control’ information that the internal auditor would need.

It was decided that the new internal auditor needed to be a person of some experience and with enough personality not to be intimidated nor diverted by other department heads who might find the internal audits an inconvenience. One debate the board had was whether it would be better to recruit to the position from inside or outside the company. A second argument was over the limits of authority that the internal auditor might be given. It was pointed out that while the board considered the role of internal audit to be very important, it didn't want it to interfere with the activities of other departments to the point where their operational effectiveness was reduced.

Required:

(a) Explain, with reference to the case, the factors that are typically considered when deciding to establish internal audit in an organisation. (10 marks)

(b) Construct the argument in favour of appointing the new internal auditor from outside the company rather than promoting internally. (6 marks)

(c) Critically evaluate Mr Kumas's belief that the internal auditor should report to him as finance director. (4 marks)

(d) Define 'objectivity' and describe characteristics that might demonstrate an internal auditor’s professional objectivity. (5 marks)

(25 marks)
Sonia Tan, a fund manager at institutional investor Sentosa House, was reviewing the annual report of one of the major companies in her portfolio. The company, Eastern Products, had recently undergone a number of board changes as a result of a lack of confidence in its management from its major institutional investors of which Sentosa House was one. The problems started two years ago when a new chairman at Eastern Products (Thomas Hoo) started to pursue what the institutional investors regarded as very risky strategies whilst at the same time failing to comply with a stock market requirement on the number of non-executive directors on the board.

Sonia rang Eastern’s investor relations department to ask why it still was not in compliance with the requirements relating to non-executive directors. She was told that because Eastern was listed in a principles-based jurisdiction, the requirement was not compulsory. It was simply that Eastern chose not to comply with that particular requirement. When Sonia asked how its board committees could be made up with an insufficient number of non-executive directors, the investor relations manager said he didn’t know and that Sonia should contact the chairman directly. She was also told that there was no longer a risk committee because the chairman saw no need for one.

Sonia telephoned Thomas Hoo, the chairman of Eastern Products. She began by reminding him that Sentosa House was one of Eastern’s main shareholders and currently owned 13% of the company. She went on to explain that she had concerns over the governance of Eastern Products and that she would like Thomas to explain his non-compliance with some of the stock market’s requirements and also why he was pursuing strategies viewed by many investors as very risky. Thomas reminded Sonia that Eastern had outperformed its sector in terms of earnings per share in both years since he had become chairman and that rather than question him, she should trust him to run the company as he saw fit. He thanked Sentosa House for its support and hung up the phone.

Required:

(a) Explain what an ‘agency cost’ is and discuss the problems that might increase agency costs for Sentosa House in the case of Eastern Products. (7 marks)

(b) Describe, with reference to the case, the conditions under which it might be appropriate for an institutional investor to intervene in a company whose shares it holds. (10 marks)

(c) Evaluate the contribution that a risk committee made up of non-executive directors could make to Sonia’s confidence in the management of Eastern Products. (4 marks)

(d) Assess the opinion given to Sonia that because Eastern Products was listed in a principles-based jurisdiction, compliance with the stock market’s rules was ‘not compulsory’. (4 marks)

(25 marks)

End of Question Paper
Answers
1. (a) The normative-instrumental distinction describes two different approaches or underlying ethical motivations. Often applied to the ways in which organisations behave towards stakeholders, it can be applied to any situation in which ethical motivations are relevant.

In the case, Jenny Harris is demonstrating a normative approach to adoption of the corporate code of ethics. It is evident from what she says that she is internally motivated. She described herself as personally driven by high ethical values and appears to see ethical behaviour as an end in itself. She tends not to take the business implications of the proposed code into account and thereby tends towards the altruistic rather than the strategic. Her attitude is informed primarily by internal motivation rather than the pursuit of external reward.

Alan, by contrast, demonstrates instrumental characteristics. He appears to be primarily motivated by business performance and sees the ethical code as a means to further other objectives (not as an end in itself). His attitude to the code of ethics is underpinned by questions about what can be gained, for the business, of the code’s adoption. Accordingly, he is strategic rather than altruistic in him motivation.

(b) This question draws upon two of Kohlberg’s three levels of moral development. In particular, it asks how the decision on possible apology for and withdrawal of the image would vary depending on whether Jenny, as the chief executive of JH Graphics, makes conventional and pre-conventional ethical assumptions.

The conventional ethical level views the moral ‘right’ according to whether it is compliant with the existing legal and regulatory frameworks and/or norms of the society or culture in which the decision is taking place. If the image was generally acceptable and offensive only to the religious group in question, it can probably be assumed that it was otherwise culturally inoffensive. It was certainly not illegal as no laws were broken. From the conventional level, therefore, there is no case for withdrawing the image.

The preconventional moral development level views the moral right as that which attracts the least punishment and the most reward. Whereas in the case of personal morality, such rewards and punishments are likely to be made at the personal level, the issues involved are more complex for organisations. Preconventional morality might ask, for example, whether the company is likely to be rewarded or punished by keeping or withdrawing the image. In this context, rewards or punishments are likely to be viewed in economic terms or in terms of boycotts or increased business arising from the publicity.

(c) This is a complicated ethical situation and the board of JH Graphics will be considering several factors in attempting to come to a decision over what to do with the offending image.

One factor likely to be considered is the possible effects of the dispute on the reputation of the company. It is not at all certain that the row will be damaging. In some industries, possibly including graphic design, to be seen to be capable of producing provocative and challenging imagery could be advantageous whereas in other situations it may be adverse.

The company will also be likely to take into account the level and direction of public/political opinion and support. The case mentions that the controversy was a major news story and it would be necessary to find out whether the independent coverage of the issue was generally critical or generally favourable of JH Graphics. If the majority of public opinion was against JH Graphics and supportive of the religious critics, that may be influential in JH Graphics considering the withdrawal of the image.

Consideration should also be given to the economic importance of the advertisement/client to JH Graphics. The case says that the client is happy with the image (and presumably untroubled by the religious controversy) but from JH Graphics’s point of view, the question concerns how much they could possibly lose if they unilaterally withdrew the rights to use the image and thereby upset the client.

The board would also be likely to consider the possible direct influence of offended religious groups on JH Graphics. The Mendelow map, which measures the influence of a stakeholder by considering its power and interest, may be helpful in determining how influential the religious group is likely to be on the wellbeing of JH Graphics. Is it, for example, large and potentially influential (e.g. in terms of mobilising opinion) or small and unlikely to have an effect?

The directors should also assess the value of all the unexpected publicity to JH Graphics? Mr Leroy is clearly of the view that is “was bringing the company free publicity and that was good for the business”. Whilst such a profile raising controversy might be damaging to JH Graphics, it might also be advantageous, especially if being seen as being willing to ‘push the boundaries’ of taste and decency is a potential source of competitive advantage. The publicity received is obviously far more than the company could afford in terms of buying publicity but this needs to be weighed against whether the publicity is good for JH or adverse.

The national culture in which the decision is taking place could have an influence on the outcome. The intensity of the debate over the importance of not causing offence will vary depending upon the national culture, which can, in turn, influenced and underpinned by historical and religious culture.

(e) This question touches on the debate over stakeholder recognition and the limits of corporate accountability and responsibility. It is in the nature of any stakeholder that they make a ‘claim’ upon the activities of the organisation. The debate is over whether that claim is recognised and whether, accordingly, the nature of the claim is taken into account in decision-making.

In this instance, it is relatively uncontroversial to recognise the religious group as a stakeholder (Freeman’s definition defines a stakeholder as an entity that can ‘affect or be affected by…’). The perceived legitimacy of the claim depends on where the limit
of accountability is drawn and the reasonableness of the claim. There is a continuum of legitimacy with, perhaps, shareholders being ‘entirely legitimate’ in making a claim at one extreme and terrorists as ‘entirely illegitimate’ at the other. The legitimacy of the religious group’s claim (they are unlikely to have a direct economic relationship with JH Graphics) depends upon where that line is drawn. It might also be pointed out that offence taken by a stakeholder doesn’t necessarily imply a responsibility towards the stakeholder.

2 (a) There is an obvious cost involved in setting up internal audit in an organisation and so it is typical to ask what factors signify the need for internal audit before one is established. Several factors influence the need for internal audit:

The scale, diversity and complexity of the company’s activities. The larger, the more diverse and the more complex a range of activities is, the more there is to monitor (and the more opportunity there is for certain things to go wrong).

The number of employees. As a proxy for size, the number of employees signifies that larger organisations are more likely to need internal audit to underpin investor confidence than smaller concerns.

Cost-benefit considerations. Management must be certain of the benefits that will result from establishing internal audit and it must obviously been seen to outweigh the costs of doing so.

Changes in the organisational structures, reporting processes or underlying information systems. Any internal (or external) change is capable of changing the complexity of operations and, accordingly, the risk.

Changes in key risks could be internal or external in nature. The introduction of a new product, entering a new market, a change in any of the PEST/PESTEL factors or changes in the industry might trigger the need for internal audit.

Problems with existing internal control systems. Any problems with existing systems clearly signify the need for a tightening of systems and increased monitoring.

An increased number of unexplained or unacceptable events. System failures or similar events are a clear demonstration of internal control weakness.

The case on Franks & Fisher highlights three factors that would underpin its need to establish internal audit. There has been growth in number of products, activities and (presumably) processes in recent times, thereby complicating the internal environment and introducing more opportunity for internal control failure. There have been problems with internal control systems (the line stoppage and Mr Kumas’s comment that, “problems with internal control in a number of areas”). Finally, there was an unacceptable event (the line stoppage) that was attributed to poor internal control. Mr Kumas confirmed this with his opinion about a ‘great need’ for internal audit.

(b) In practice, a decision such as this one will depend on a number of factors including the supply of required skills in the internal and external job markets. In constructing the case for an external appointment, however, the following points can be made. Primarily, an external appointment would bring detachment and independence that would be less likely with an internal one. Firstly, then, an external appointment would help with independence and objectivity (avoiding the possibility of auditor capture). He or she would owe no personal loyalties nor ‘favourites’ from previous positions. Similarly, he or she would have no personal grievances nor conflicts with other people from past disputes or arguments. Some benefit would be expected from the ‘new broom’ effect in that the appointment would see the company through fresh eyes. He or she would be unaware of vested interests. He or she would be likely to come in with new ideas and expertise gained from other situations. Finally, as with any external appointment, the possibility exists for the transfer of best practice in from outside – a net gain in knowledge for Franks & Fisher.

(c) The first thing to say is that Mr Kumas’s belief is inappropriate and it would be an unacceptable for the internal auditor to report to a divisional director who might be the subject of an internal audit. The reasons put forward in favour of his request are spurious. All of Mr Kumas’s information and expertise would be available to the internal auditor in any event, with or without his oversight of the function. Reporting to Mr Kumas would be a clear threat to the independence of the internal auditor as he/she would not be objective in auditing the accounting and finance department. The advice from relevant codes and guidelines would also strongly counsel against My Kumas’s proposal. The Cadbury code is typical where, point (g) under the ‘role of the internal audit committee’ emphasised the independence of the internal audit function from management. Mr Kumas’s request should be refused.

(d) Objectivity is a state or quality that implies detachment, lack of bias, not influenced by personal feelings, prejudices or emotions. It is a very important quality in corporate governance generally and especially important in all audit situations where, regardless of personal feeling, the auditor must carry out his or her task objectively and with the purpose of the audit uppermost in mind. The IFAC Code of Ethics explains objectivity in the following terms (Introduction, clause 16): “… fair and should not allow prejudice or bias, conflict of interest or influence of others to override objectivity.”

It thus follows that characteristics that might demonstrate an internal auditor’s professional objectivity will include fairness and even-handedness, freedom from bias or prejudice and the avoidance of conflicts of interest (e.g. by accepting gifts, threats to independence, etc.). The internal auditor should remember at all times that the purpose is to deliver a report on the systems being audited to his or her principal. In an external audit situation, the principal is ultimately the shareholder and in internal audit situations, it is the internal audit committee (and then ultimately, shareholders).
In the first instance, the information systems put in place to provide information for the risk committee. This would generate it would review and assess the effect of internal controls on risk. A committee made up of independent, non-executive directors would bring scrutiny to Thomas on two fronts. There is evidence that Thomas may be relatively inexperienced, having been in post for only two years, and the way that he dealt with Sonia's entirely legitimate enquiry shows some evidence of immaturity and/or impatience. Non executive presence would be able to challenge and act as a counterweight to this failing. Non-executive directors would also bring scrutiny of Thomas's leadership over strategy, especially (in the context of the risk committee) the wisdom of his 'very risky' strategies.

The opinion shows confusion over the meaning of the term 'compulsory'. Whilst in a principles-based jurisdiction, compliance is not legally compulsory, it is required for the stock market listing. Accordingly, compliance is effectively compulsory if the company wishes to enjoy the benefits of its listing. Companies in principles-based jurisdictions are subject to 'comply or explain' in that non-compliance needs to be explained in terms of specific areas of non-compliance and the reason for non-compliance. Compliance is also necessary for market confidence in the Eastern Products stock in that the market would be likely to devalue a stock that was a consistent non-complier. Finally, shareholders and stock markets are entitled to challenge the explanation for non-compliance if they aren't satisfied with the explanation given in the annual report.
1 (a) 1 point for each relevant point made on normative up to a maximum of 4
1 point for each relevant point made on instrumental up to a maximum of 4
(Maximum of 8 marks)

(b) 1 mark for evidence of understanding the terms up to a maximum of 2
1 mark for application of each to case up to maximum of 2
(Maximum of 4 marks)

(c) 2 marks for each relevant point made
(Maximum of 10 marks)

(d) 1 marks for each relevant point made.
(Maximum of 3 marks)

(25 marks)

2 (a) 1 mark for each factor identified and briefly discussed up to a maximum of 7.
1 mark for each factor applicable to Franks & Fisher up to a maximum of 3.
(Maximum of 10 marks)

(b) 1 mark for each relevant point identified and briefly described.
(Maximum of 6 marks)

(c) 1 marks for each relevant point made
(Maximum of 4 marks)

(d) 2 marks for definition of objectivity
1 mark per relevant characteristic identified and briefly described up to a maximum of 3 marks
(Maximum of 5 marks)

(25 marks)

3 (a) 2 marks for definition of agency costs
1 mark for each problem identified and briefly discussed up to a maximum of 5
(Maximum of 7 marks)

(b) 1 mark for each relevant point identified and briefly described on conditions for intervention up to a maximum of 7.
1 mark for each relevant point made on Eastern House up to a maximum of 3.
(Maximum of 10 marks)

(c) 1 mark for each relevant point made
(Maximum of 4 marks)

(d) 1 mark for each relevant point made
(Maximum of 4 marks)

(25 marks)