

# Examiner's report

## P1 Governance, Risk and Ethics

### December 2011



#### General Comments

December 2011 was another successful exam for many P1 candidates. As always, I congratulate successful candidates and their tutors. For those that did not pass this time, though, I hope the remarks in this report will be helpful when preparing for a future P1 exam.

The format and rubric of the December 2011 paper was the same as previous diets. The paper was divided into two sections, with section A comprising the compulsory Question 1 for 50 marks and section B containing three 25 mark questions with candidates having to select two from three. There was no widespread evidence that candidates were pressed for time.

In this paper I examined two of the new (for June 2011) elements of the P1 study guide: C3g on objective and subjective risk assessment appeared in Q1(c)(ii) and C3f on ALARP appeared in Q1(c)(iv). I wrote a technical article on these important study guide additions in May 2010 to emphasise their importance. I will discuss these below in more detail but just to mention here that some candidates did these question parts quite poorly. This should serve as a reminder that technical articles are written to help students to understand parts of the study guide and some may even help with answering questions in future exams. There are several technical articles on the ACCA website written by either myself, or other informed authors, and I strongly advise P1 candidates to study these as a part of their preparations for P1 exams.

#### Specific comments

##### Question One

The case for the compulsory (50 mark) question 1 was on Coastal Oil, a petrochemical company that had experienced difficulties with an explosion on a deep sea oil extraction rig. It was similar to a real-life case that arose with a company that had suffered an explosion on a rig with a resultant loss of life and a number of other negative consequences.

As in previous exams, I used the longer case in question 1 to examine several areas of the study guide including content from the ethics component (study guide section E). Also as before, a careful and detailed analysis of the case itself was essential to achieve good marks.

Part (a) asked about corporate codes of ethics for ten marks. For five of the marks, candidates were asked to describe the general purposes of a corporate (not to be confused with a professional) code of ethics. These should have been relatively straightforward for most well-prepared candidates and indeed, most candidates were able to collect some marks here. Many achieved all five marks.

For the second 5 marks of the 10, the requirement was to evaluate Coastal Oil's performance against its own stated ethical aims. These were clearly set out in the third paragraph in the case and many candidates were able to correctly identify these. Marks were awarded where candidates were able to show, from the case, how the company had failed to meet its own ethical standards. A common mistake was to list the five areas (full compliance with regulation, etc.) but then to describe what the terms meant rather than searching the case for evidence to evaluate the company's performance.

Part (b) was about mandatory and voluntary disclosure and in particular, the potential materiality of environmental risk disclosure at Coastal Oil. The first task was to explain what the two terms meant (voluntary and mandatory) and then to give some examples to demonstrate understanding. Most candidates were able to gain some marks here although quite a lot were not able to say any more than that mandatory was required by law and that voluntary was not. This missed the point about how listing rules also place disclosure requirements



on companies, including, in many jurisdictions, details of the company's corporate governance, executive remuneration, etc.

Part (c) was the multi-part requirement. Candidates were asked to answer each part, sequentially, in the form of a speech by Susan Ahmed, CEO of Coastal Oil. She was asked to appear before a special committee of the national legislature and wanted to use the speech to explain several things to the committee about the company's internal controls and risk management. In particular, she wanted to explain the IC failures and to respond to points made against the company in the controversy that had followed the explosion of the oil rig.

Questions involving the examination of a case to pick out and explain internal control failures have been used before on P1 papers on several occasions. Part (c)(i) required Mrs Ahmed to explain to the committee where IC failures had occurred. The case itself, as in previous questions of this type, was seeded with the information required to provide a comprehensive answer. Because (in the last paragraph of the case) the Coastal Oil board agreed that she should provide a full and uncensored statement to the legislative committee, there was no reason for Mrs Ahmed to conceal or play down particular failures. Accordingly, the best answers were those that carefully and systematically explained (i.e. did more than just identify) each of the five major IC failures in the case. Those that explained internal controls in general terms, perhaps explaining the importance of ICs, received low or no marks because they failed to adequately analyse the case.

Part (c) requirements (ii) and (iv) were both from the new content on risk that I mentioned in the introduction to this report. Both were done with variable degrees of success. In part (ii), most candidates were able to distinguish between subjective and objective risk assessment but fewer were able to gain the marks for arguing against Senator Jones's view. The point here was to explain to the committee that Senator Jones did not appreciate the subjective nature of risk measurements and that probabilities of risk events happening are often very difficult to estimate. Subjective assessments, importantly, are not invented or fabricated, but are based on less-than-scientific assessments which are sometimes difficult for some stakeholders to understand.

Part (iv) seemed to be difficult for many candidates. I covered the ALARP principle in a technical article in 2010 and whilst many candidates were able to show some evidence of knowing what it was (sometimes with the help of a simple graph), fewer were able to weave it into the speech as required.

Part (iii) on health and safety risk required candidates to explain what it means, and then to explain what can increase this risk in an organisation. This should have been straightforward because it was mainly bookwork. Some candidates defined the term and then did not do so well on explaining the factors.

There was a full spread of marks awarded for the presentation itself. As usual there were four professional marks available. Some made no attempt to frame their answers in the form of a speech. Others (wrongly) began their answer with 'Dear committee' and ended with 'Yours faithfully'. Another error was to frame it as a memo with 'To: Committee, From: Mrs Ahmed' or similar. It is important to be able to judge the tone of an answer based on what the question asks in terms of format. I have raised this before in my examiner's reports and I would again encourage candidates and their tutors to work on these formats as a part of preparing for future P1 exams.

## **Question Two**

The case in question 2 was about a debate in Geeland over how corporate governance should be regulated. It contained a quotation on how a principles-based system might be applied and also one from Anson Company, which had a temporary compliance failure in respect of its executive chairman. Both of these quotations were based on real-life examples, slightly modified for the purposes of making them fit the exam paper. Most candidates attempted this question.



Part (a) first asked candidates to distinguish between rules and principles-based approaches to corporate governance. This has been examined before and is a central part of the P1 study guide and so I was pleased to see that most who attempted the question did quite well on that task. The more ambitious task followed, which was to critically evaluate the quotation in the case about the application of principles in corporate governance. The task was to explore the two sides of the debate which some candidates did very well indeed whilst others seemed not to understand the task at all. This should have been a straightforward task for a candidate who had studied the debate over rules and principles but there was evidence that some candidates appeared not to grasp this important area of the P1 study guide.

Part (b) also examined a central part of the corporate governance debate: the separation of the roles of chief executive and chairman. The case study described a situation at Anson Company in which Mr Klunker had temporarily adopted the role of executive chairman. In line with best practice in a principles-based jurisdiction, the company had made a 'comply or explain' statement in its annual report and this was the subject of part (c). Part (b) was done quite well overall but some candidates struggled to actually assess the 'comply or explain' statement in part (c). The task in part (c) was not to explain what 'comply or explain' meant (this was a common mistake) but to take an informed view on the statement provided by Anson on explaining why it had an executive chairman and was thus in breach of the relevant code provisions.

### Question Three

This question used the example of a utility company privatisation to explore issues of executive remuneration, market risk and proxy voting. A number of governance issues can occur with organisational and environmental changes (such as privatisation) including the succession of senior officers in the company.

Part (a) was about CEO Helen Evans's reward package before and after the privatisation of Dale Gas. It seems when some candidates see questions such as this one, they enter into a description of the components of a reward package, even if it is clearly not required. This requirement had two clear tasks, to explain the purposes of a CEO's reward package (not its components) and then to review the factors that might influence the level of the rewards for Mrs Evans after the privatisation (i.e. once Dale Gas becomes a private sector organisation).

Most candidates were able to explain the ideas of attract, retain and motivate as the main purposes of a reward package although those that only listed the terms without reference to the case did not receive good marks. More difficult for some candidates was the second part of the requirement. The case discussed a number of issues relating to Mrs Evans's pay, including her strategic skills, the views of shareholders, Mrs Evans's abilities, market rate (the case mentioned other companies of similar size), government regulations that had previously constrained her pay, and the opinions of some that believed the doubling of her reward to be unreasonable. So there was a lot in the case to use in answering this requirement. The secret to getting the marks was to carefully examine the case and to use that as the basis for the answer. Some merely listed the main points without explaining from the case and those answers were not so well rewarded.

Part (b) was less well done. Again, it contained two tasks. The first should have been straightforward as it was a simple definition, but it seemed to confuse many candidates. The study texts use a number of definitions of market risk but in the context that Tom Nwede used it in the case, the relevant definition is market risk as it refers to the share value of Dale Gas (Tom Nwede was an institutional investor). One of the P1 study texts defines it thus: *Market risk is a risk of loss due to an adverse move in the market value of an asset – a stock, a bond, a loan, foreign exchange or a commodity – or a derivative contract linked to these assets.* The point is that the loss of a key executive can increase market risk because it can unsettle investors or threaten the value of those assets upon which future cash flows, and hence market values, depend.

A common problem with part (c) on proxy voting was to recognise that it involved voting without attending the general meeting but then to fail to explain the advantages. For a fund manager like Tom Nwede, who may have



many individual companies in a managed fund, it would simply be impossible to attend every company annual meeting. Most institutional investors, that have confidence in the board of a particular company, will be content to allow the chairman to vote on their behalf in order to avoid the need to study each motion and attend in person to vote.

#### **Question Four**

This was the least attempted question in section B of the paper. It covered the Gray, Owen and Adams continuum and the idea of social responsibility, both of which are important components of the ethics section of the P1 study guide. The case concerned Biggo Manufacturing, a company that was managing a number of stakeholder issues associated with the construction of a factory extension. It addressed issues similar to those examined in earlier papers where a certain project would have positive and negative impacts.

Part (a) began with what should have been a fairly straightforward requirement, which was to explain the meaning of rights and responsibilities. This is a key part of the citizenship of a business (from study guide section A7d) and is actually also a theme in earlier F-level ACCA papers. The more difficult task was to describe the ways in which rights and responsibilities are interpreted by pristine capitalists and deep greens, these being the two ends of the Gray, Owen and Adams continuum. A common mistake in this question was to list and describe the seven positions on the continuum. Again, a careful reading of the question should have avoided that error.

Part (a) is a good example of how theory (the Gray, Owen and Adams continuum) needs to be applied in a P1 question. It is not sufficient just to know what they are. To gain high marks, candidates also need to be able to use what they know to describe the two positions from a particular perspective, in this case, in terms of what the two positions say about rights and responsibilities.

Part (b) was done better than part (a) overall which was pleasing. In this case, two people were clearly described in the case, and candidates had to use the evidence from the case to identify and justify which of the seven positions best described the two people. Robert Tens was expedient and Margaret Heggs was a pristine capitalist. Where candidates sometimes went wrong was to get Margaret Heggs right but Robert Tens wrong, sometimes identifying him as a social contractarian. Again, a close and detailed reading of the case should have prevented such an error.

Part (c) was sometimes treated as a bit of an afterthought with some answers being very short, despite it being worth 9 marks. There were three tasks: to define social responsibility as used by Albert Doo in the case, and then to examine Biggo's decision about the play area from short and long term perspectives. Most who attempted it were able to gain some of the marks for defining social responsibility. The tasks about short and long term shareholder interests were often not done well. To achieve high marks, candidates had to engage with the case and to show how the decision would have different issues in the short term and, with the management of certain key stakeholders in the longer term.