

Examiner's report

P1 Governance, Risk & Ethics

December 2013



General Comments

I am pleased to report that December 2013 saw many people pass the P1 paper. As usual I congratulate successful candidates and their tutors. I know that studying P1 can be challenging as well as fascinating and so am always pleased to see hard work rewarded with a passing mark.

The paper was similar in its approach, tone and level to the previous P1 papers so a well-prepared candidate who had worked through the past papers should have been in a strong position with this paper. This is best practice for all P1 candidates, of course. All of the previous P1 papers, with answers, are on the ACCA website, and candidates are strongly advised to work through each of those in preparation for their own 'live' P1 paper.

In issuing comments on candidate performance in the December 2013 paper, I have one general point to make which is about the importance of verbs in the exam paper. In all P1 papers, it is important to first establish what the verb in the question is asking the candidate to do. Some candidates failed to do this, even although there was evidence that they understood the content of the question, and the result was that they did not gain as many marks as they should have done. In question 4(a), for example, the question asks candidates to 'describe the main ways in which directors of companies can leave the service of a board'. This is clearly a list that many candidates learn in preparation and so it was disappointing to see bullet lists that did obey the verb to 'describe'. The same issue obviously applied to other questions also.

Question One

The case in question 1 was about some issues surrounding a long oil pipeline on Hiakaisland. As with other P1 cases in section A of the exam, this is based on a real-life situation of a long pipeline and some of the problems that have been associated with it. The requirements in this question, as usual in question 1, covered a range of areas on the P1 study guide.

Part (a) asked about various aspects of sustainability. In part (a)(i), most candidates were able to define sustainability, often using the Brundtland definition or similar. This was contrasted with the idea of economic sustainability which, whilst important to the government of Exland, which can often be at the cost of environmental sustainability. Most candidates were able to obtain good marks for this part. Part (a)(ii) was more challenging for many candidates. The task was to discuss the tensions that exist between environmental and economic sustainability. These are issues that are at the heart of the sustainability debate in business and so are important themes in understanding how businesses can become environmentally sustainable.

Part (b) was about the four risks detailed in the case. Each one was described in terms of the probability of its occurrence and its potential impact. From this information, candidates should have been able to map each of the four risks on the risk assessment matrix. From its position on that matrix, a management strategy for each risk can be ascertained from the TARA framework. Many candidates were able to do this successfully and gain high marks. Other students correctly assessed each risk but then seemed to be confused over strategy selection. It was pleasing to see many candidates receiving full marks, however. There were two marks from the ten for an explanation of the subjective nature of risk assessment. This was sometimes weakly attempted, perhaps as an afterthought, but it is important to realise that not all probabilities or impacts can be accurately measured like a scientific variable (such as temperature, altitude, etc.).

Part (c) asked about issues concerning Mr Hoo's reward package at Hiaka Energy. There were two tasks in the requirement. The first, to explain 'labour market conditions' regarding executive pay, directly examined section



A5a of the study guide. The second task asked about Mr Hoo's relatively high level of reward in comparison to local pay levels on Hiakaisland. Because the market for chief executives is sometimes an international market, rates of pay can be high by local standards, especially if the job is located in a developing country and this was the case with Mr Hoo's appointment at Hiaka Energy Company. When a large rewards disparity exists between junior and senior levels in a company then the high rewards are often criticised, but there are arguments on both sides and a critical evaluation of these was required in the second task in this requirement. It was this second task that presented a difficulty to many candidates. On the one hand, HEC had to pay the international market rate to recruit to the senior position but that placed Mr Hoo in a difficult position as he was the highest paid person in the Hiaka region.

Part (d) contained two requirements and asked candidates to present their answers in the form of a business letter from Mr Hoo to the industry minister of Wyland. The four professional marks were awarded for the format, tone, logical flow and persuasiveness of the letter. This point has been made in previous examination reports, but these should be straightforward marks for a well-prepared candidate who had rehearsed the different potential communication types. A business letter is an important form of business communication and one that I hoped would be more in evidence than was the case in many answers.

The letter had to address two issues. Part (d)(i) asked about why internal controls were difficult to implement at HEC. Weak answers produced a list of the characteristics or benefits of internal controls, neither of which were correct approaches. It was necessary to carefully study the case to draw out the evidence in it that made the implementation of internal controls difficult. Some answers analysed the case and produced a list of the relevant points but these were not as well rewarded as those that obeyed the verb in the question, which was to 'explain'. A key issue in this requirement was to appreciate that a number of factors, many unavoidable, made internal controls hard to implement at HEC and to understand that sometimes, internal control solutions are not as straightforward as might be hoped.

Part (d)(ii) was not done as well as part (d)(i) overall. Because of the problems on Hiakaisland and the Gojo incident, the company had decided to establish an internal audit function. The point of this requirement was to discuss how internal audit might provide assurances to improve the controls in HEC. The requirement gave a clue as to how to go about this ('basing your answer on the main roles of internal audit'). A typical weak answer was to reproduce the 'roles of internal audit' as a list but of course this was not what the requirement was asking for. For six marks, this should have received a time budget of approximately eleven minutes but some candidates preferred to leave this and move on to other parts of the exam paper.

Question Two

The case scenario for question 2 was on Sarbanes Oxley in the United States, and in particular the section 404 provisions on the external reporting of the adequacy of internal controls. This was a popular question for P1 candidates in the December 2013 exam and many candidates achieved good marks for the question.

Part (a) was mainly book work and should have been familiar material to any P1 candidate. It contained two tasks: to distinguish between rules and principles, and then to explain the disadvantages of a rules-based system. It was important to take these two tasks in turn as 'combined' answers were often confused and less clear than those that took each in turn. Most candidates were able to gain some marks in this requirement and it was one in which thorough revision was rewarded.

In part (b), candidates were required to define agency and then go on to discuss the benefits of maintaining a system of internal control over financial reporting in a rules-based jurisdiction. The first task in this requirement



(to define agency) was evidently more straightforward than the second. Control over financial reporting was a key outcome of the Enron failure and a prominent issue within many corporate governance codes including Sarbanes Oxley. Many candidates produced weak answers on the benefits of internal controls over external reporting, although this is a central theme in sound corporate governance. It is not possible to produce reliable external reporting without the internal controls necessary to ensure the accuracy and robustness of the reporting.

Many candidates seemed to struggle with part (c) and some didn't answer it at all. The case scenario set out the situation with section 404 of Sarbanes Oxley and the requirement asked about how difficult it would be for smaller companies to comply with it. The point here is partly that the costs of compliance are proportionately higher than for larger companies, partly because of fixed costs that apply to all companies regardless of their size.

Question Three

The case in question 3 concerned a charitable organisation called Help-with-life (HWL). As with many charities, HWL receives funding from several sources, including some that comes from a local government authority that imposes conditions upon HWL as a condition of its funding. There has been a trend in recent years for some non-corporate entities, such as public sector organisations and charities, to adopt 'best practice' governance approaches and HWL is an example of a charity seeking to do this.

Part (a) asked about nomination committees and contained two tasks. The first task was mainly bookwork and required candidates to explain the roles of a nominations committee. Most candidates that attempted this question were able to do this task quite well. The second task was less well done. The task was to describe how HWL's nominations committee might actually go about appointing new directors and was more straightforward than some answers suggested. Some candidates saw clearly what this was asking and produced excellent answers whilst others produced confused and poorly-formed answers that seemed to misunderstand the meaning of the question.

Part (b) asked about the advantages of diversity on the board of HWL. Note that this, although touching on a general theme, requires careful analysis of the case because it is specifically about diversity on the board of HWL. So whilst a good knowledge of the importance of diversity in general was a good starting point, the high marks came with an explanation firmly linked to HWL's specific situation. A common weaker answer was to reproduce the advantages of board diversity with little or no linkage to the unique situation of HWL whilst the better answers realised, for example, that 40% of HWL's funding was dependent upon the charity demonstrating diversity on its board and that this funding might be threatened if HWL failed to comply.

Part (c) also contained two tasks, with the first being answered better than the second overall. The first task was to explain 'corporate social responsibility' and markers accepted a range of expressions of this explanation. Again, however, an explanation was required and a shorter 'definition' was less well rewarded in terms of marks. The second task was to discuss the ways in which CSR and ethical stances differ between a charity and a 'for profit' business. Of course the whole basis of their reasons to exist are completely different for these two types of organisation. Many answers were sketchy and incomplete on this, with some candidates writing very little.

Question Four

This question was about a technological failure at Lobo Company. The responsible director was Frank Bub but there was discussion in the case that the rest of the board had been open to criticism also, because of their collective responsibility for major capital investments. Because of the extent of his failure, it was decided that Frank Bub should leave Lobo Company.

Frank Bub's departure was the subject of part (a). Part (a)(i) was a relatively straightforward task to describe the ways that a director can leave a board. Most of the study texts contain a list of several reasons and this was well done by most of those that attempted it.

Part (b)(ii) was somewhat more complicated. Given the information in the case, the task was to select and justify an appropriate way for Mr Bub to leave Lobo Company. Although it was possible to select any means of departure in theory, the case specifically mentions that the board's desire was to remove him 'as cheaply as possible' and that he had 'nine months remaining on his renewable three year contract'. Given the circumstances of the case, the mechanism most likely to be the cheapest for the company would be to allow him to serve the remainder of his nine month contract and then allow him to retire by rotation by not putting himself forward for re-election upon the completion of that nine-month period. Markers did accept other answers if they were coherently argued but to get good marks for this, answers had to show how the selected mechanism would have met the 'as cheaply as possible' criterion mentioned in the case. This, again, shows and underlines the importance of studying the case in sufficient detail to gain advantage in answering the requirements.

Part (b) explored some of the issues surrounding the technological risk that was materialised in the case with the failure of an IT system. The first task was to briefly explain technological risk, with the word 'briefly' signifying that a long explanation was unnecessary. This was fairly straightforward for most candidates. There were two further tasks however, which were done less well by many candidates. The first was to discuss the problems that led to the technological failure at Lobo. This involved studying the case and drawing out the management failures that Mr Bub made, leading to the IT system failure. There was no substitute for careful study of the case to achieve these marks. The third and final task was to explain how these failures by Mr Bub may affect the confidence that shareholders have in the entire board of Lobo. Even though the case clearly shows that the main failures were made by Frank Bub, the fact that he was allowed to make these mistakes reflects badly on the rest of the Lobo board and this might affect the confidence that shareholders have in the board.

Part (c) asked about the fundamental principles of professional ethics. These have been examined before on previous P1 papers but on this occasion, they referred to Frank Bub who the case said was a professional engineer. A common answer to this question was to list or describe each of the fundamental principles in turn. Whilst it was important to know what these were, the requirement was to discuss those 'which Frank Bub failed to observe'. So, again, it was necessary to analyse the case for evidence and to narrow the discussion down to those that Mr Bub offended against. This highlights again that it is not sufficient to understand the content of the P1 study guide, but also to apply it to situations raised in case scenarios. This requirement was an example of that.