Examiner's report

P1 Governance, Risk & Ethics
June 2012

General Comments
The June 2012 P1 paper, as in previous diets, was based on a compulsory multi-part question for 50 marks in section A, followed by a choice of two from three 25 mark questions in section B. I am pleased to report that many people passed the exam with some achieving excellent marks, and as usual, I congratulate all successful candidates and their tutors for all the hard work and commitment they put into the teaching and learning.

The paper itself was similar in tone and feel to previous P1 diets and there should not have been anything too surprising or difficult for well-prepared candidates to cope with.

Specific Comments

Question One
The case in section A concerned Hayho Company. In the scenario, Hayho is considering two possible foreign investments and both options have particular issues associated with them. These issues include different risk and internal control problems, and the fact that the projected returns on the two options are significantly different. The Jayland option would also involve dealing with its president, Mr Popo, who, as well as having a questionable record on human rights, also demanded a personal royalty from Hayho (effectively a bribe) if the company chose to invest in his country.

A further complicating factor was the presence of a human rights lobbying organisation called 'Watching Business' (WB) that was already monitoring Hayho because of its past behaviour in another country (Arrland). WB was influential and was warning Hayho not to invest in Jayland because of the record of Mr Popo's government.

Part (a) asked about the risk profiles of the two options (Jayland and Pealand). Drawing upon the idea of risk appetite, candidates were required to explain risk appetite and then to demonstrate how different risk appetites might affect which option may be chosen. This task was done well by most candidates although some failed to explain risk appetite as a continuum, saying instead that risk appetite meant risk seeking. In fact, companies and individuals can have either a high, low or medium risk appetite. In the scenario, the Jayland option was the higher risk (with a higher potential return) of the two and so would have been attractive to companies with a higher risk appetite or which were more risk-seeking.

Part (b) asked candidates to use the seven step AAA model to examine the choice between Jayland and Pealand. A minority chose the wrong framework for this (employing, for example, the Tucker framework or the Gray, Owen and Adams continuum) but most were able to correctly identify the seven AAA questions. Not all of these were presented in the correct and logical order.

There were a range of approaches taken. The AAA framework is used to establish the ethical norms of the company and/or culture in which it operates, and to weigh the consequences of the two options, before finally selecting the option most in line with those norms and with the more favourable consequences. Some candidates failed to achieve higher marks here by producing only a shallow analysis of each stage or by confusing the things to consider under each question. But overall, this question was done quite well by the majority of candidates.

There were two tasks in part (c). The first, for 4 marks, was to describe the general purposes of an internal control system. This was bookwork and should have been straightforward to any well-prepared P1 candidate. It was frustrating that many candidates failed to take into account the verb, 'describe'. It was not enough to 'list' or produce a short bullet list. To get full marks for this first task, markers were looking for a brief description of each general purpose as asked for in the question.

The second task in part (c) was to examine the case and to assess (to identify and say how important) the internal control challenges that Hayho would encounter of it chose the riskier Jayland option. The case contained several of these, based on what Emily Baa said about life in Jayland. Again, the verb was important here. It was not enough just to pick the main challenges out and list them. To get the higher marks, candidates had to assess each in terms of how it would represent a challenge to Hayho. This was a more intellectually ambitious task than merely identifying them from the case and listing them.

The remainder of question 1 was a two-part requirement, and as in earlier P1 papers, four professional marks were available for this section. Because of the situation at Hayho, the CEO, Helen Duomo, sought advice from Emily Baa who was familiar with Jayland. The requirement was to prepare briefing notes for Helen Duomo covering a range of important issues with regard to the choice between Jayland and Pealand.

Part (d)(i) contained two tasks. The first of these was to discuss what accountability means and most candidates made a fair attempt at this. The more ambitious task was to discuss how the Mendelow framework can be used to predict the influence of the pressure group, Watching Business. Most candidates were able to show evidence of understanding of the Mendelow matrix (that power x interest = influence) but fewer were able to use this to show how the variables applied to WB. The point here was to use the evidence in the case to discuss the sources of power and interest specifically for WB and this was done with varying degrees of success.

Part (d)(ii) also contained two tasks. The first was to briefly explain the agency relationship in the case (between Hayho and Quark Investments) and most candidates were able to attract some marks here. It was pleasing to see that most P1 candidates had a good idea of what an agency relationship is. The second task was to explain, using evidence from the case, the particular reasons why Watching Business, as a prominent stakeholder, should be carefully considered by Hayho. This task was done poorly overall perhaps because it involved a detailed analysis of the case to establish the sources of WB's influence.

As in previous diets, candidate attempts to gain the four professional marks were patchy. Some made good attempts whilst others made no apparent attempt at all.

Question Two

The scenario in question 2 was about a recently retired chief executive, Mr Louse, who was giving a speech on various aspects of corporate governance. Having enjoyed a long and successful career in business, he had a number of views that he presented in his speech.

He expressed views on the actual independence of non-executive committees and on risk committees. These subjects were asked about in parts (a) and (b). Part (c) was about differences in risk management between large and small companies.

Part (a), about the independence of non-executive directors (NEDs), touched on a debate about whether NEDs should be fully independent of executives in order to bring more scrutiny, or familiar with the industry, in order to bring more relevant strategic expertise. It was disappointing to see that some candidates answered a question that was not set. Some produced the list of the roles of NEDs (strategic, risk, people and scrutiny) and some discussed regulation. Neither of these were correct approaches.

The first task in part (a) was to define 'independence'. Because this is such an important concept in corporate governance, and one of the underpinning concepts in A1(d) of the study guide, I was pleased to see that most candidates were able to attempt this task. The second was about the debate on independence and this was less well done with a wide range of approaches being taken.

There were two tasks in part (b). Candidates were firstly asked to describe the roles of a risk committee. The most common error with this was, as with question 1, part (c), to disobey the verb (which was 'describe'). It was clear that many candidates knew these roles but a short bullet list is not a description. The best way to answer a question such as this is to start with the single short sentence and then to expand that with a description to show the marker that the thing being described is fully understood. Where bookwork marks like these are available on a professional paper like P1, it is essential that they are gained if a high mark overall is to be attained.

Other common errors in this task (as well as just producing a bullet list) included discussing the factors that determine whether the company should establish a risk committee, and also regulatory and listing rule issues with risk committees. Neither of these was asked for in the requirement.

The second task in part (b) was to criticise (to say what is wrong) with some comments that Mr Louse made in the case about the roles of risk committees in Zogs Company. This involved picking out the various comments and then showing how Mr Louse misunderstood risk committees. This involved discussing the true roles of risk committees and showing how risk committees were not in fact an inconvenience but rather an essential part of sound corporate governance. Some candidates were able to extract the quotations from the case but were then unable to enter into a meaningful criticism of the views expressed. These answers received fewer marks than those able to include the criticisms.

Part (c) asked about whether risk mitigation systems were more important in larger companies than in small companies. The answer should have included points including strategic and regulatory issues but this part was the weakest for many candidates who attempted question 2. Some sought to explain, often without using a meaningful argument, that large and small companies were the same with regard to risk systems and such answers were not well rewarded.

Question Three

In question 3, the case was about the progression of student accountants in an audit practice. One of the students, Polly Shah, was given permission to continue despite being rated as ‘poor’ in her appraisal. This was against normal practice and it emerged that managing partner, Jack Hu, was a friend of Polly Shah’s family.

Part (a) was, accordingly, on conflicts of interest. There were two tasks: to define the term, and then to assess the consequences of Jack Hu’s behaviour. Most candidates were able to make an attempt at a definition, but the second task was less well done. Rather than considering the consequences, some candidates continued writing about how conflicts of interest can occur and this was clearly not what the question was asking. It is important to realise that corruption and malpractice in business have serious consequences for a range of people and this question sought to explore some of these consequences. Some of the consequences affected Jack Hu himself, showing that bad practices such as those he demonstrated, are often self-defeating as well as being a very bad example to others.

Part (b) was not well answered overall. It required candidates to consider the problems that had occurred at Jojo and then to describe four ethical safeguards that might prevent a recurrence of the events described. Candidates who reflected on how the events arose in the first place and how these might be addressed, received the best marks for this part. Again, short bullet points with little detail (i.e. no description), were not well rewarded.

The case raised issues about the performance of Jack Hu as a senior manager in the audit practice and these were examined in part (c). In a public company, shareholders are collectively responsible for deciding whether they are satisfied with each director’s performance in the job. In the case of a smaller partnership, where partners need to appraise each other, these issues can be a little more complicated.

Again, there were two tasks in part (c): to explain the criteria used to measure the performance of individual directors (not of entire boards) and then to examine the particular circumstances at Jojo to discuss why individual performance measurement might be difficult there. This part was done poorly overall. Perhaps candidates had considered the performance of boards but not of individual directors of those boards.

Question Four
This was a question about a family business that decided to convert to a public company and it examined a number of issues around that theme. Part (a) asked about the differences in governance arrangement between a family business and a listed company, and then asked about how the family's ability to manage as they wished would change after the flotation. The first task was done quite well overall but candidates sometimes failed to recognise the importance of listing rules in the second task. In order to comply with listing rules and to fit in with the expectations of institutional investors, the management would have to change quite radically from that of a family business. These changes were what Gustav Lum was concerned about when he feared that the Lum family would 'lose the freedom' they had previously enjoyed.

Part (b) asked about induction programmes and continuing professional development for directors. A common error was to discuss the contents of an induction programme when the question specifically asked for an assessment of the benefits. A common error was to treat the two under the same heading when in fact the two (induction and CPD) are quite different and serve different needs within a company.

I was surprised to see that many candidates struggled to achieve high marks in part (c) on unitary and two-tier boards, despite this topic having been on previous P1 papers. There was evidence that some candidates did not understand the roles of NEDs on the two types of boards nor how the two approaches might affect the control that the Lum family might have over the company after flotation.

Question 4 was about a common issue in corporate governance. Businesses do occasionally change their legal form and such changes are almost always associated with governance changes.