

# Examiner's report

## P1 Governance, Risk and Ethics

### March 2016



#### General Comments

The examination consisted of two sections. Section A contained one question for 50 marks and section B contained three questions of 25 marks each from which candidates had to answer two questions.

P1 questions are based on case scenarios and those candidates who studied the information in the case and applied it suitably in their answer were well rewarded. There is a temptation for candidates to use bookwork type answers and reproduce remembered notes and candidates taking this approach are unlikely to be well rewarded. There is sometimes a temptation to spend more time answering the questions and requirements that candidates are happier with but most candidates need to answer all of the questions on the paper to receive a passing mark so good time budgeting is important.

#### Question One

The case scenario in Q1 was about a public listed company whose main activity is as a short-term lender of money. The services provided were under public scrutiny because of stories of borrowers who were falling into a continuous cycle of debt which they could not afford to repay. The government recently passed an important piece of legislation which would require a change in business model for the company and the requirements for the question were based around the impact of those changes and covered several areas of the study guide.

Part (a) was worth ten marks and contained two tasks. The first task required analysis of the impact the new legislation had on three groups of stakeholders and candidates needed to identify from the case the positive and negative impacts to the stakeholder groups. Candidates performed well on this part of the task and a good answer on the first task enabled many candidates to gain good marks on this part of the question overall. The second task required a brief recommendation of internal control changes that should be made to ensure compliance with the new legislation. Many candidates failed to be able to suggest changes to the credit checks that would be needed to ensure that all loans were compliant with the business model.

Part (b) was worth six marks and contained two tasks. The first task was to describe the function of internal audit and candidates performed well on this task. The second task was to address the internal audit challenges faced by the head of internal audit in introducing the new system. Many candidates described the challenges but failed to explain how they could be addressed and did not gain as many marks. Many candidates fell into the temptation of spending more time on this than the six marks indicated.

Part (c) was worth ten marks and contained two tasks. The first task was to explain independence and candidates performed well on this task. The second task was to discuss how the independence of the audit function could be increased which required candidates to identify the current weaknesses and then make recommendations for improvements. With requirements b) and c) it was important to answer plan so that there was no duplication in a candidates' answer. Although this does not impact the marks achieved it does impact time management and many candidates failed to recognise the different requirements for each of parts b) and c) and duplicated the content for both. These candidates might have benefitted from answer planning the requirements first as the P1 paper would not require a candidate to answer the same content in two requirements in the same question.

Part (d) contained three requirements and was to be written in the form of a statement from the board to the shareholders. The four professional marks were awarded for clarity, persuasiveness, tone and flow of the statement. These should be straightforward marks for a well prepared candidate who has rehearsed the different communication types that can be examined in P1. Evidence on this paper is that candidates are not clear how a statement should be structured and many candidates gave the answer in the form of a letter. Candidates would be well advised to remind themselves of the communication types and the correct ways of structuring each requirement type.

Part (d) (i) was worth eight marks and contained two tasks. The first task was to explain the nature of non-executive committees in a public listed company. Many candidates failed to recognise the key word which was committees and just explained about non-executives. It was disappointing to see that many candidates saw non-executives and introduced the four roles of the non-executive directors (people, risk, strategy and scrutiny) and this was clearly not the approach to the requirement. It is always important to work out what the requirement is actually asking for. The second task was to discuss the importance of committee structures given the changes to the business model. Weak answers produced a general discussion of committee structures and did not gain as many marks. Candidates who answered in context and related the importance to the change in business model were well rewarded.

Part (d) (ii) was worth six marks and required a justification for introducing a risk management process, given the legislation changes to short-term lending described in the case scenario. It was necessary to carefully study the case to draw out the evidence of the need for effective risk management and those candidates who managed to do this achieved the highest marks. Many candidates gave bookwork answers to the risk management process and failed to gain as many marks.

Part d (iii) was worth six marks and required an explanation of the importance of risk and internal control reporting to shareholders, given the new legislation. Many candidates failed to recognise the key word was shareholders and explained about internal reporting rather than external reporting and failed to gain as many marks.

## **Question Two**

The case scenario was based on a successful listed company, much of the company's success had been credited to the CEO, a trained accountant, who had just informed the board of his retirement. The CEO has a large number of share options which he can exercise at any time over the next year. The case scenario then explains how the CEO is using his power to pursue his own personal interest and his decisions not being aligned with his fiduciary duty to shareholders.

Part (a) was worth eight marks and contained three tasks. The first task was to explain the term conflict of interest in the context of governance. Many candidates went straight into case examples and failed to gain all of the bookwork marks. The second task was to use evidence from the case to show how the CEO's behaviour presented a conflict of interest, many candidates did this part of the task very well. The third task was to state a course of action that the CEO should take. Many candidates failed to identify that he should declare his interest and leave any decision to the remainder of the board.

Part (b) was worth nine marks and contained two tasks. The first task was to describe the agency relationship in the case scenario. Many candidates gave a bookwork answer to the agency

relationship failing to relate agency to the case scenario and therefore did not gain as many marks. The second task was to explain how clear accountability could increase trust between the principal and the agent thereby reducing the agency cost. Candidates needed to recognise that compromised trust results in agency cost and should have evidenced this from the scenario, explaining agency costs as part of their answer. Many answers lacked sufficient content to obtain all of the marks available.

Part (c) was worth eight marks and contained two tasks. The first task was to explain the meaning of probity and many candidates did this part of the task very well. The second task was to criticise the ethical behaviour of the CEO with respect to honesty. Candidates needed to find all of the dishonest behaviour that had been exhibited by the CEO and criticise this making reference to his accountancy training and being bound by a code of ethics which has clearly been breached. Again as with part b) of this question many answers lacked sufficient content to obtain all of the marks available.

### **Question Three**

The case scenario was based on a company producing electronic guidance systems for long-range missiles and other weapons. The company had seen rapid growth and needed a significant injection of capital for further investment. The company had registered offices in two jurisdictions one operating under a rules-based governance system and one under a principles-based governance system and were looking to make a choice about which jurisdiction should be chosen for the company floatation.

Part (a) was worth twelve marks contained three tasks. The first two tasks were bookwork and required candidates to explain the advantages and disadvantages of listing in a rules-based governance jurisdiction. Many candidates did this task very well. The third task was to discuss other factors which would ultimately guide the decision on where to list. Many candidates continued to give governance factors and failed to consider factors beyond the consideration of corporate governance, as an example, candidates could discuss the country's legal system and how it might affect the operation of the market and would not want to be impeded by avoidable legislation. Candidates who only considered governance factors did not gain as many marks.

Part (b) was worth eight marks and contained two tasks. The first task was to explain, using examples, the role of external stakeholders in governance. Many candidates ignored the role in governance and just explained the general role of the external stakeholders and discussed suppliers and customers with no reference to how they are involved in the governance arrangements. Candidates who did explain the governance role of external stakeholder made better choices with their examples of stakeholders like the government and the stock exchange who have specific roles in governance. The second task was to discuss the influence which institutional investors could have on the governance arrangements. Candidates should have made reference to the potential power that institutional investors can have which is displayed in voting. Their votes can influence the way the company is managed and governed, in the extreme influencing those who govern on their behalf as they can vote to remove directors from the board.

Part (c) was worth 5 marks and required exploration of the factors which influenced the development of corporate governance codes in principles-based jurisdictions. The case scenario gave an example of a developing country that is trying to encourage foreign inward investment and some candidates explored the benefits of principles-based governance to this country. Some

candidates explored the corporate failures and issues with dishonest directors as factors that influenced principle-based codes. Both approaches were acceptable and given credit.

#### **Question Four**

The case scenario was based on a company producing chemicals for use in the agricultural sector, some which were highly toxic. The case then gave information that the company's manufacturing and storage facility was situated in an area where earthquakes could occur, but the area had not experienced any major tremors for several years. The possibility of an earthquake which could destroy the factory and cause a major environmental incident was of grave concern to the board so a scientific team had also been consulted and have offered a best guess of what they perceive the risk to be.

Part (a) was worth 8 marks and contained two tasks. The first task was to evaluate the difficulties of risk perception. Many candidates recognised that the difficulty of risk perception is the quality of the information available upon which to assess the risk and that with a subjective risk perception it is very difficult to assign a value to impact and likelihood. Most candidates who answered the question were able to do this quite well. The second task was to describe the problems with the perception of risk shown by the scientific team and required a careful study of the case evidence to draw out the evidence that made the assessment difficult and therefore the limitations in choosing a suitable risk mitigation strategy and on the impact of resource decisions.

Part (b) was worth ten marks and contained three tasks. The first task was to explain the stages of an environmental audit. Some candidates confused the audit with a risk assessment and so failed to obtain marks. The second task was to explain the benefits of conducting an environmental audit and many candidates did this task very well. The third task was to assess the importance of reporting good quality information to the board. Many candidates described the qualities of information without relating assessing the importance to the board and did not gain as many marks.

Part (c) was worth seven marks and contained two tasks. The first task was to explain the term environmental footprint. Many candidates did this bookwork task very well. The second task was to assess how the activities of the company in the case scenario contributed to its footprint. Those candidates who engaged with the case and evidenced their answer obtained good marks.