

# Examiner's report

## P1 Governance, Risk and Ethics

### March 2017

#### General Comments

In keeping with the usual rubric for P1 papers, there was a compulsory section A question worth 50 marks and this was followed by a choice of two from three 25 marks questions in section B of the paper.

Performance of students was generally good when students used the information in the case studies and the exam allowed them to show their knowledge and apply it to the scenarios set. However,, it is important to repeat some of the points made in previous examiner's reports. Firstly, obey the verb. If the verb in the question says 'explain' then a definition is insufficient. If it says 'discuss' then a list is insufficient. This is very important, especially at the Professional level of ACCA's qualification. Second, it is necessary to properly read and study the information in the case to fully answer a requirement. A bookwork-type answer is rarely sufficient and those candidates who take that approach are unlikely to be well-rewarded in terms of marks. Third, time needs to be tightly budgeted. There is sometimes a temptation to spend more time answering the 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.

Candidates are reminded of the exam resources available to students via the website which contain many technical articles, study support videos, syllabus updates and exam technique guidance which provide an invaluable sources of information. Examples of technical articles relevant to this particular paper include Corporate Governance – from the inside out, COSO's Enterprise Risk Management framework, Internal audit and Independence as a concept in corporate governance. Future candidates are reminded to make full use of these resources as part of their overall learning strategy.

#### Question One

The subject of the case scenario in the first question was a state bank which was the largest bank in the country. The scenario identified a number of issues being faced by the bank; the bank had failed to comply with regulatory norms, risks needed to be addressed urgently and the overall control environment and processes were inadequate. The bank had engaged the same external auditors for over 20 years and the audit partner was a long-term friend of the bank's finance director. The external auditors had approved the bank's going concern statement without qualification despite the audit partner having privately expressed his doubts to the finance director about the long term sustainability of the bank. A prominent journalist investigating the worrying trends in the asset and liability profiles of several banks in the country had interviewed the finance director of the state bank and asked for qualification of the bank's financial position. The journalist felt that he received an inadequate response and reported problems with the bank's financial position on national television. This created panic for customers at the bank with deposit holders queuing to take their money out of the bank. As a consequence the government were forced to intervene urgently and rescue the bank by taking a 49% share in the bank in return for an injection of cash to increase the bank's liquidity. In an attempt to restore confidence in the banking sector a new law was passed requiring the banks to report on their material risks and how they were being managed.

Part (a) was worth ten marks and required the candidate to explain why internal audit would be important to the bank. Generally this was not well answered as many candidates produced a generic bookwork answer on the role of internal audit and failed to relate the answer to the many issues at the bank that could be underpinned by internal audit. P1 is a Professional Level exam and requires candidates to blend knowledge and application when answering questions. A good candidate identified the problems at the bank and then explained how internal audit would be able to support and strengthen the current position.

Part (b) was worth six marks and required the candidate to explain why the audit committee should review the internal audit report before it goes to the executive board. Most candidates recognised that the board had previously put a positive light on the bank's financial position and that an independent review of the robustness of the internal control systems would be required to protect the interest of the shareholders. It was important that the true state of affairs was communicated to the shareholders. Many candidates obtained good marks on this part of the question.

Part (c) was worth eight marks and required the candidate to explain why it was in the shareholders' interests for the bank to put the external audit contract out to tender and allow other audit firms to bid for the contract. Many candidates recognised the familiarity threat which would compromise the independence of the audit. Candidates also recognised the highly improper behaviour of the auditors in not providing the correct information to the shareholders regarding the financial position of the bank. Putting the contract out to tender would safeguard the independence, allow for best practice to be secured and deliver better value for money, all serving to reassure shareholders. Many candidates obtained good marks on this part of the question.

Part (d) contained three requirements and was to be written in the form of a draft statement for the shareholders. The four professional marks were awarded for flow, tone, persuasiveness and structure of the statement. The professional marks should be straightforward marks for a well prepared candidate who has rehearsed the different communication types that can be examined in P1. 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 required the candidate to explain the board's fiduciary duty. Many candidates recognised that this was a duty of skill and care and the duty to act in good faith in the best interest of the shareholders and obtained good marks on this part of the question. The second task required candidates to explain how the bank failed its shareholders in respect of the board's fiduciary duty. Candidates needed to study the case scenario and recognise the incidents when the board had failed to act in the interest of the shareholders. Many candidates failed to draw out the evidence from the case which is surprising given P1 is a professional paper and has always required candidates to use the case scenario to support their answers.

Part (d) (ii) was worth six marks and required the candidate to discuss the importance of making a reliable going concern statement to shareholders and the stock exchange. Many candidates recognised that the importance of reliable information to shareholders for decision making regarding their investment portfolio and the value of their shareholding. Many candidates obtained good marks on this part of the question.

Part (d) (iii) was worth eight marks and contained two tasks. The first task required the candidate to discuss the main risks. Most candidates were able to recognise that the main risks, such as liquidity and reputation risk. The second task required the candidate to suggest how each risk could be managed to make a more stable and sustainable bank in the future. Weak candidates provided a general explanation of how the risks could be managed. Candidates who looked at each risk in turn and suggested a sensible approach to managing each risk were well rewarded.

### **Question Two**

The case study was based on a small, but well established, firm of accountants. The scenario focused on a long standing client of this firm, who had been successful, until a major customer had gone into liquidation resulting in it suffering a large bad debt. The client's finance director is confident that the situation will become stable in due course. The case reveals that the client owes the firm of accountants a material sum for outstanding invoices

for the previous audit and tax advice provided. In support of the client one of the audit partners at the firm of accountants has agreed that payment for the outstanding invoices can be spread over a number of months. The client also needs the support of its bank to address the liquidity problem. The bank will only offer the support if it is presented with audited financial statements by the end of the month. The audit partner has promised the client that their bank will have the audited financial statements on time. The current audit is well underway but the audit plan has only just been reviewed and signed off by the audit partner. The audit manager for the client has correctly identified going concern as the area of the audit attracting greatest risk and that this would be worsened if the bank was not convinced by the audited financial statements due at the end of the month. The case scenario identifies that this could result in the client going into insolvency and so its debt to the firm of accountants would not be honoured.

Part (a) was worth seven marks and contained two tasks. The first task required the candidate to describe the roles and responsibilities of the firm of accountants as a body representative of the audit and accounting profession. Many candidates focused on their responsibility to adhere to an ethical code which is only one aspect of their responsibility and did not gain as many marks. Candidates who expanded the role and responsibility to include having the required skills and knowledge and the responsibility to act in the broader public interest were well rewarded. The second task required the candidate to assess the influence of the firm in the situation in the scenario. Many candidates did not attempt this part of the question. Those candidates that recognised the influence extends beyond the audit client to other stakeholders in particular the bank's reliance on the audited financial statements were well rewarded.

Part (b) was worth eight marks and required the candidate to explain how threats to independence would arise and affect the ethical behaviour of the audit partners. Many candidates were able to identify the threats to independence but did not go on and explain how this affects the ethical behaviour. Intimidation was a threat evidenced in the scenario. A weak candidates identified intimidation as a threat to independence and explained the generic meaning of intimidation without going on to evidence the intimidation issue in the case scenario. A strong candidate would have used the information in the case scenario to identify, using intimidation as an example, that the audit partner has agreed the new credit agreement for the client and so might use his position to intimidate the audit manager to comply with his instructions and suppress any issues found at the client. This would have prevented the audit manager from exercising objectivity. Candidates who structured an answer around this approach were well rewarded.

The performance on part (b) of this question highlights the need for candidates to read the question requirement carefully to ensure they are very specifically answering all of the question requirement.

Part (c) was worth ten marks and required the candidate to describe the safeguards which could be implemented at the firm of accountants to manage the ethical conflicts arising from the dealings with the client in the scenario. Candidates who gave sensible suggestions for managing the ethical conflicts, such as rotating the audit partner and continued ethical awareness training, were well rewarded.

### **Question Three**

The case scenario was based on a major national retailer who had uncovered a serious issue within the financial accounts. In accordance with stock market regulation they had issued a profits warning statement detailing that its pre-tax profits had been over-stated. As a result of the error, profits for the first half of the year were around 25% lower than forecast, well below initial expectations causing the share price to fall and it had not yet recovered. Investigation revealed internal financial reporting systems and associated internal controls were wholly inadequate allowing significant errors to go unchecked. The board as a whole were heavily criticised and at an

extraordinary general meeting some of the board were asked to tender their resignations and the new board to establish a risk committee to ensure such problems would never arise in the future.

Part (a) was worth seven marks and contained two tasks. The first task required the candidate to explain the responsibilities of the board of the company in the case scenario for ensuring effective financial reporting and internal control systems. The second task was to explain how the work of a risk committee can help the board fulfil its responsibilities. Many candidates recognised the role of the board and the risk committee and obtained good marks on this part of the question. Many candidates did write all they knew about the role of the board which displays poor time budgeting as the marks available were for their role in effective reporting and internal control systems.

Part (b) was worth eight marks and contained two tasks. The first task required the candidate to describe the objectives of internal control systems. Many candidates just listed the objectives of internal control and made no attempt to describe them and did not gain as many marks. The second task required the candidate to explain how meeting the objectives could help prevent further misreporting or error at the national retailer. Weak candidates made no attempt to relate their answer to the case scenario. Good candidates joined the two tasks together in their answer describing the objective first, such as detection of fraud and error as an objective, then using the case scenario to evidence this failure and then suggesting that management controls comprising regular checks would identify significant errors to prevent misreporting in the future. Candidates who structured an answer around this approach were well rewarded. Candidates should consider carefully the verbs used in the requirements and construct their answer accordingly.

Part (c) was worth ten marks and required the candidate to explain the general principles of disclosure and communication which the board of the national retailer should follow when it briefs its shareholders. Many candidates recognised the importance of principles like transparency and completeness and scored well on this part of the question.

#### **Question Four**

The case scenario was based on a company operating a high-speed rail network. The network was highly subsidised by the government as it was critical infrastructure for the economic prosperity of the country. In return for the subsidies the government had set challenging performance targets, the results of which had to be published monthly and any significant variances had to be explained to the transport ministry. The scenario highlighted some of the risks faced by the rail network and how the network were proactively managing risk by employing an enterprise risk management framework. The case scenario described a recent weather-related accident and how a prompt response reduced the number of deaths and injuries sustained.

Part (a) was worth eight marks and required the candidate to describe how risk awareness could be embedded into the rail network's culture and values. Many candidates obtained good marks on this part of the question.

Part (b) was worth twelve marks and contained two tasks. The first task required the candidate to discuss the risks which the rail network is exposed to. Many candidates obtained good marks on this part of the question. Many candidates also discussed how the risks could be managed which was not part of the requirement and displays poor time budgeting. The second task required the candidate to explain how the ALARP principle in risk management relates to impact and probability. Many candidates explained what ALARP stood for which was actually in the case scenario. Many candidates explained what was meant by likelihood and impact which was not the question requirement. A good candidate recognised that some risks like the weather-related accidents could not be completely avoided but they can be reduced to an acceptable level and that an acceptable level of

risk becomes a trade-off between the assessment of the likelihood and impact of risk materialising and the cost to the rail network of taking action to mitigate it.

Part (c) was worth five marks and required the candidate to assess how the rail network had used risk management techniques to mitigate the various types of business and financial risks which it faced. Many candidates delivered a book work answer on TARA and did not use the case scenario. Candidates who answered in context and used the case evidence to assess the risk management techniques were well rewarded and many achieved full marks. The performance on this part of the question highlights the need for candidates to recognise when an answer needs to be entirely evidence based.