



# Examiner's report

## P1 Governance, Risk & Ethics

### September 2015

#### 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 simply draw upon knowledge rather than apply this knowledge in their answers and reproduce remembered notes. Candidates taking this approach are unlikely to be well rewarded.

#### Question One

The case scenario in Q1 was about a private family owned company delivering public sector care services. The services provided by the company were outsourced to them by the local government authority. The requirements were based around governance arrangements for a small private company fulfilling public sector contracts and how they might address the service delivery failures that were identified in the case scenario.

As with many previous cases this scenario was based on a real-life situation and the requirements covered several areas of the study guide.

Part (a) was worth eight marks and contained two tasks relating to corporate governance and agency (this was knowledge essentially) and then to compare corporate governance in a large listed company and a smaller privately owned company (the case scenario could be used to support the candidates answer as this was based around a private family owned company).

The knowledge element of the task was well answered by candidates, but in the second part of the task many candidates failed to recognise that in both private sector businesses and in large listed companies, one aspect of corporate governance is about delivering acceptable long-term economic returns to investors, but the difference is in the agency relationship. The relationship has to be aligned in a large listed company in order to maximise investor confidence but in a privately owned company agency problems are less likely to exist as the company is usually owned and managed by the same people.

Many candidates also failed to recognise that governance is also important when revenues are generated from contracts that are awarded by commissioning bodies like regulatory authorities and the government. Gaining and maintaining the full confidence of these bodies and the service users is also likely to be the focus of governance structures.

Part (b) was worth ten marks and contained two tasks: both addressing remuneration issues in the public sector as against the private sector.

Many candidates recognised higher degrees of risk and increased complexity equate to higher rewards for a CEO of a large listed public company, but failed to consider that when delivering public sector contracts there are constraints from government spending budgets. Public sector spending is often funded by taxation. There is a lot of political and economic pressure to get best value from this revenue so stakeholders react negatively if they feel the payment is too high.

Some candidates also failed to explain that management motivations also differ and 'a public sector ethos' usually correlates with lower salaries.



Part (c) contained two tasks. Many candidates did not obey the verb in the first task and as it required an explanation therefore a definition was insufficient. Candidates needed to relate both tasks to the case and those who just demonstrated their knowledge as an answer did not gain as many marks as those that applied that knowledge to the case situation. Candidates also failed to recognise the difference between a corporate code of ethics and a governance code and many candidates discussed governance guidelines when the question clearly stated corporate code of ethics.

Part (d) contained two requirements and was to be answered in the form of a business letter. The four professional marks were awarded for layout, flow, tone and structure of the letter. 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 students are not clear how a business letter should be structured. Candidates would be well advised to remind themselves of the communication types and the correct ways of structuring and using language differently in each requirement type.

Part (d) required candidates to address issues around internal controls to care service providers. Weak answers produced a general explanation of the importance of internal controls. Candidates who answered in context and related the importance of internal controls to the issues in the case were well rewarded. The answer required proposals for suitable internal control changes which would address the service delivery failures described in the case. It was necessary to carefully study the case to draw out the evidence of the failures and those candidates who managed to do this achieved the highest marks. Many candidates simply identified how typical control failures in general might be managed without reference to the case and failed to gain as many marks.

## **Question Two**

The case scenario was based on a bank providing financial services. Due to the global economic crisis of 2008, the bank had got into difficulty and the government has intervened with a sizeable investment in return for a majority equity shareholding.

The professional members of staff sold insurance policies to clients irrespective of whether the client actually needed them. This was happening because the professional staff were rewarded via a generous commission scheme. The auditors had issued an unmodified report and had not identified the irregularity that was prevalent in the bank.

Part (a) asked the candidates to complete two tasks relating to the fundamental principles which should underpin professional behaviour and to assess the extent to which these principles were evident in the bank. Many students were well rewarded for their answers in the first task, but in this second part did not find the necessary evidence from the case. These candidates might have benefited from highlighting the evidence when reading through the case to ensure maximum marks for this part of the question.

Part (b) asked the candidates to do two tasks. Candidates needed to discuss issues with commission based reward schemes; this could include staff being focused on their own short term gain and will mean that they focus on making the sale today rather than the future consequences. Candidates needed to expand on this lack of objectivity when a system is based on personal gain and how sales became quantity based rather than quality based. The consequence of this being damage to a company's reputation. The second task required a discussion of how the commission scheme could have been adapted to encourage more ethical practice. Candidates performed better on the second task finding it easier to recommend improvements. Answers might include introducing 'cooling off periods', staff being better supervised and changes in the design of the remuneration package so rewards were based on other aspects of business performance not just sales volumes'.

Part (c) contained two tasks relating to external audit. Candidates needed to recognise that the primary responsibility of external audit is to report to shareholders on whether, in their opinion, the financial statements are free from material misstatement which could be caused by fraud and error. Auditors need to be aware that risks are happening and reliability comes from their knowledge of the company and the industry and then ensuring that the audit encompassed tests of controls around the company and industry requirements. Students also needed to assess the consequences of the auditor's failure. Candidates recognised that an unmodified report would lead to shareholders and other stakeholders having confidence in the financial statements and would believe nothing was awry in the company. The case informed candidates that the company's equity value had been impacted, candidates needed to expand on this referencing the government as a shareholder and the impact on the public interest of the company. The reputational consequence for the auditors could also be explored in the answer.

### **Question Three**

The case scenario was based on a company who serviced hotel chains and who started life as a small family concern and had experienced rapid growth and needed to attract additional capital so had recently listed on the stock exchange. The company operated in one country and complied with the country's governance codes. The remit of the audit committee included all aspects of risk management and so the company had not created a separate risk committee.

The company's expansion strategy included entering a new country that had experienced rapid growth and domestic prosperity. The government in the new country operates very low levels of indirect tax which has stimulated the hotel industry. This attractiveness is offset by a number of risks that will be faced by choosing to operate in the country.

The question related to the function and roles of a risk committee. Many candidates did this task very well. The second task was to discuss the advantages of a risk committee to the company in the case. Many candidates continued to make general statements about the role and function of the committee and did not relate their answer to the recent listing and entry into the new country both increasing the need for more expertise. Candidates should also recognise that the audit committee might not be in a good position to continue to manage all aspects of risk management and a separate committee helps the board to ensure that adequate risk management systems are in place to meet every eventuality.

Part (b) contained two tasks, the first task being answered better than the second overall. Candidates should have explained that the spectrum of risk appetite goes from risk adverse to risk seeking and comprises two elements that of level and capacity and needed to discuss how the appetite of the company in the case had been influenced by its corporate strategy and the risks it has chosen to bear. A well-structured answer discussed its rapid growth and its venture into a new country as examples of this. The company is risk seeking due to the many risks in the new country offset by the high returns from the economic growth and low indirect taxation. Many candidates just discussed the many risks the company was facing and did not correlate this to the return. Candidates that only focused on the risks did not gain as many marks.

Part (c) concerned strategic and operational risks arising from the entry into the new market and how they could be controlled. The risks were evidenced in the case. Many candidates were not very specific about the controls and gave very general answers utilising the TARA framework in their answers. As an example some candidates suggested that the trading risk could be transferred without going on and saying they could take out an insurance policy covering the value of the goods which could be lost or damaged on the long journey to the new country. Candidates who were very general in their answers did not gain as many marks.

#### **Question Four**

The case scenario was based on an individual who had received a surprise inheritance. The new found wealth was to be invested in a portfolio of shares. The investments were only in companies with strong management and a credible corporate social responsibility record. Information was given in the case regarding one potential investment.

Part (a) concerned the information value that voluntary disclosures provide to shareholders. Most candidates who answered the question were able to do this quite well. Some candidates failed to relate the answer to shareholders and did not gain as many marks.

Part (b) concerned information in annual reports and which aspects would help the individual in the case to make an investment decision based on his personal criteria. Many candidates discussed many different types of information, but failed to relate the information to the criteria and failed to gain as many marks. Candidates could have considered as examples the biographical details of directors to determine the strength of management and the social and environmental reports to determine their environmental footprint and their concern for society at large.

Part (c) required candidates to assess the appropriateness of the potential investment evidenced in the case using a particular model. This question was answered very well by many candidates. The students who engaged with the case and evidenced their answer gained more marks.