

# Examiner's report

## P1 Governance, Risk and Ethics

### June 2011



#### General Comments

June 2011 was another successful exam for many P1 candidates. As always, I congratulate successful candidates and their tutors. For those that did not pass this time, though, I hope the remarks in this report will be of help when preparing for a future P1 exam.

The format and rubric of the June 2011 paper was the same as previous diets. The paper was divided into two sections, with section A comprising the compulsory Question 1 for 50 marks and section B containing three 25 mark questions with candidates having to select two from the three. There was no widespread evidence that candidates were pressed for time.

In the paper itself, I examined some of the new content on risk that I introduced into the study guide for this and subsequent diets. This was in question 2 on dynamic risk, and on related and correlated risk. Also, in Q3a, I examined content that I covered in an earlier technical article on governance differences between corporate and non-corporate forms of organisation. As in previous exam reports, I would remind candidates preparing for P1 exams not only to ensure they have studied the entire P1 study guide (and not 'question spotted'), but also to make themselves familiar with the content of technical articles on P1. These are published in Student Accountant magazine and are also posted on the ACCA website.

#### Specific Comments

##### Question One

The case scenario in question 1, as previously, was a detailed case to enable a number of areas of the study guide to be examined. The scenario concerned a number of issues associated with the development of a new model of car, the Bobo Foo, and it was a story loosely based in a real-life story of some years ago. In an attempt to produce a new car model quickly and cheaply, a design flaw was introduced that was potentially dangerous to users. When confronted with a choice of what to do about it, the Bobo company chose to pay out compensation to affected users rather than retool the plant because, over the lifetime of the car's production, it was by far the cheaper option even although the company knew the car to be unsafe.

As usual, I used the scenario to examine a number of outcomes which not only sampled the study guide and also required candidates to answer at more than one level intellectual level. Also as previously, the requirements were based heavily upon the case meaning that candidates had to study the case in some detail to gain marks.

Part (a) was an 'internal controls' question and contained two tasks. The first task was to explore the circumstances that led to the fuel tank problem on the Bobo Foo. The verb 'explore' was used here to enable candidates to have latitude in responding to this task. Many candidates were able to correctly pick out and explore the causes of the problem. These included cost pressures, a shortening of the usual development time, ignoring the outcome of a crash test and failure to challenge senior management on the issues associated with these problems. A careful study of the case enabled stronger candidates to gain the majority of the marks for this task.

The second task in part (a) was to propose ('identify and explain') internal control measures capable of mitigating the fuel tank risk in future car development projects. This was less well done than the first task in part (a). Again, a careful consideration of the specific problems at Bobo was the secret to gaining marks. Candidates that attempted to answer this using a memorised list of points from a study text or other notes were less well rewarded.

Part (b) was a Kohlberg question. This was the third time I have examined this and on each occasion, I have used people in the case to illustrate the different levels. In December 2007, the issue concerned a decision on



how to react to the overestimation of a mineral and in June 2009, it concerned the level of moral development of the 'rogue trader' Jack Mineta. In December 2007, the three levels were represented by the three people in the case but in this paper, two were conventional and one was pre-conventional. There was nobody at the post-conventional level. I think some candidates assumed there must have been a post-conventional person and Kathy Yao was the person most often, but incorrectly, associated with this level. Many candidates were able to get most of the first six marks for the 'explain' requirement but others became confused when allocating James Tsakos, Kathy Yao and Vernon Vim to the appropriate levels.

Part (c) was about annual and extraordinary general meetings, and asked about the value of an EGM for Bobo and its shareholders. Candidates were required to distinguish between AGMs and EGMs, and then explain the advantages of an EGM for Bobo in the case. The first part was done better than the second. To get marks on the 'advantages' part, candidates had to analyse the case to see why it was important for Mr Tsakos, Bobo's CEO, to face the shareholders in person.

Part (d) contained two parts and also had the four professional marks. The professional marks were allocated for the construction of a speech that Mr Tsakos was to give to the shareholders at the EGM. As usual, there was a full range of approaches to this including candidates who (wrongly) wrote their answers in the form of a letter, a memo or with no apparent structure at all. In terms of the substance of part (d)(i), the chief executive was required to explain his roles as CEO in managing the issues described in the case. Some candidates did poorly on this, perhaps confused by the 'in managing the issues described in the case', but a well-prepared candidate familiar with the usual roles of a chief executive was able to do quite well if the roles were discussed in context.

Part (d)(ii) was about defending the company's decision to pursue the 'compensation option' over the 'universal recall' option but to do so from a 'pristine capitalist' perspective. This means that candidates had to argue from a particular ethical perspective. Lists of Gray, Owen & Adams's seven positions were not rewarded at all and those with the highest marks were usually those able to argue using the information in the case, for example arguing that the financial cost of the 'compensation option' was much less than the alternative and was thus greatly to the benefit of shareholder value.

## **Question Two**

This question was mainly about risk. I used the question to examine some of the new study guide content on risk, namely the dynamic nature of risk and the idea of related risk. I cited six unspecified risks faced by YGT company and used letters A to F to identify them. Parts (a) and (c) were done quite well on the whole and parts (b) and (d) were very variable.

There were two tasks in part (a): to criticise Raz Dutta's beliefs (that risks 'didn't change much' and 'hardly ever materialised') and to explain why risks were dynamic. This question referred to new study guide section C1c and which I explained in the technical article I wrote on these study guide changes in May 2010. Many candidates were able to discuss the notion of risks arising as an organisation's environment changes but fewer were able to gain the 'criticise' marks which, in my view, were actually quite straightforward to get (see the published answer on the ACCA website).

Part (c) also drew on new study guide content: section C3h on related and correlated risk. I was pleased to see many candidates gaining the marks for explaining related risks, and many were also able to describe how risk E, an environmental risk, was positively correlated with risk F, a reputation risk. The point here was that in some cases, increased environmental losses can result in deterioration of a company's reputation (i.e. a rise in reputation risk) and because both risks rise and fall together, they can be said to be positively correlated as opposed to negatively correlated.

There was a lot of variation in the answer to part (b) on TARA. I worded the case very carefully to make it clear where each of the four risks (A, B, C and D) fitted on the impact/likelihood risk assessment map. Once the risks were correctly plotted on the map, the risk strategies should have been clear. Candidates who were familiar with the way that risk strategies were plotted on the TARA map could usually get good marks on this question, often getting the full six marks. The areas of risk assessment and risk strategies are central to the risk element of the P1 study guide and well-prepared candidates should know these areas well in preparation for P1 exams.

Part (d) was poorly done by some candidates. As a fourth requirement, some candidates seem to have done this as a 'tag on' perhaps used to budgeting time for three requirements in section B questions rather than four. It was worth 6 marks, however and illustrates why candidates should time budget for as many requirements as there are in a question (this was not a widespread problem but was evident in a few cases). Well-prepared P1 candidates should be able to address the concept of risk awareness and how this is important as part of an overall risk management strategy.

### **Question Three**

The case in question 3 was about a charity, HHO, registered in Laland. Horace Hoi was clearly a difficult character, living a lavish lifestyle on charitable proceeds gained from the charity, and at the same time reporting very misleading and highly selective financial information. The content drew partly upon a technical article I wrote in October 2010 (which is on the ACCA website).

Part (a) drew partly upon the content of the October 2010 technical article (which itself was an expansion on content in study guide section A1f). There were two tasks in part (a) and both were knowledge based, so should have been straightforward to candidates that were familiar with the relevant part of the study guide and who had studied the relevant technical article. This part was done quite well by many of those who attempted question 3.

Part (b) offered more of a challenge because after a relatively straightforward opening (to define transparency), a higher level verb ('construct') invited candidates to examine the case in detail and to pick out those things that were wrong at HHO and to use those issues to argue in favour of greater transparency. HHO had clearly used the legal framework in Laland to conceal transactions and to provide no effective external reporting. The result of the lax legal constraints in Laland was that Mr Hoi had accumulated substantial personal wealth, almost certainly from the donations of well-meaning donors concerned about animal suffering. There was plenty of ammunition in the case to construct an argument for greater transparency at HHO.

Part (c) brought together study guide content on audit committees and internal controls. There were clearly a number of internal control deficiencies at HHO and the question asked candidates to consider the roles of an audit committee (assuming they knew what these roles were) and how these might be applied to HHO's failings. A typical poor response to this was to list the roles of a risk committee without applying them meaningfully to the case.

### **Question Four**

This question was based around a discussion of the IFAC code of ethics (2009) and described the behaviour of an accountant, Ann Koo, who took a bribe when awarding supply contracts. It was not necessary to know about the IFAC code in advance as the case gave a quote from the code that was used as the basis for the requirements. The first part (part a) was about ethical threats, part (b) was a 'criticise' question and part (c) asked about insider dealing. In general, part (a) was done well and parts (b) and (c) were done less well.

The general ethical threats in part (a) were usually correctly identified and described. A second task in part (a) was to discuss how 'gifts' and 'hospitality' can give rise to specific ethical threats. This was less well done than the first task although most well-prepared candidates were able to show a connection between accepting gifts and one or more of the five ethical threats.



In order to achieve high marks on part (b), candidates had to know about the 'public interest' and also to be able to scrutinise the case to study Ann's behaviour. In criticising her, an explanation was required of how her behaviour was inconsistent with her duty, as an accountant, to uphold the public interest. Overall, responses to this part were probably less than would be expected given the time budget for 10 marks. Many candidates made a few points but failed to adequately draw the crucial link between accepting a bribe and serving the public interest.

Part (c) was about insider dealing, which is sometimes called insider trading (from A3(e)(vii)). This was the first time I had examined this on a P1 paper and, again, the quality of answers was variable. Most could correctly explain what the terms meant but some candidate answers petered out in a second paragraph where they struggled to develop the points about it being illegal and unethical.