ACCA P1 - Governance, Risk & Ethics

Workbook
Lecture 1 - Governance
Illustration 1

In the country of Laland, aid organisations registered as charities are not subject to the same financial reporting requirements as limited companies (this is not the case in many other countries where they are treated equally in law). One person to take advantage of this is Horace Hoi who has led his vigorous campaign in favour of animal protection for the past 25 years. As a highly competent self-publicist for his charity and an engaging media performer, he has raised the public profile of his charity substantially. He can and does raise large amounts of money for his charity through his personal charm and passionate appeals on television and in large meetings of supporters. His charity is called the ‘Horace Hoi Organisation’ (HHO) and its stated aim is to ‘stop animals suffering’.

Mr Hoi has recently become the subject of criticism by the media because of allegations that he lived a lavish lifestyle and personally owned a large mansion and a number of classic cars. The HHO recently bought a private jet to support Mr Hoi in his travels around the world for speaking engagements and for his work for the HHO charity. One journalist reported that most of the donors to HHO are well-meaning individuals, mainly of modest means, that care greatly about animal suffering and who would be ‘horrified’ if they knew of the luxury in which Mr Hoi lived.

Despite the fact that Mr Hoi had claimed that he personally takes only a modest salary from the organisation for his work, a journalist recently estimated Mr Hoi’s personal wealth, thought to be gained from the HHO, to be around $10 million. When challenged to disclose the financial details of the HHO and Mr Hoi’s own personal earnings, a HHO spokesman simply replied that this was not required under the law in Laland and that the HHO was therefore fully compliant with the law. The HHO has refused to join a group of other charities that have undertaken to make full financial disclosures despite it not being mandatory in law. The HHO says that although it does produce financial information for the charity and tax authorities, it has no intention of making this information public. The HHO also makes no disclosures about its governance structures and was once criticised as being ‘intentionally opaque in order to hide bad practice’.

In yielding to the media pressure to provide some information on its financial affairs, HHO eventually published a pie chart on its website saying that its expenditure was divided between animal shelters (57%), field work helping animals (32%), administration (6%) and other causes (5%). This was the totality of its public financial disclosure.

Required:

Define ‘transparency’ and construct the case for greater transparency in the governance of the Horace Hoi Organisation.

(8 marks)
Illustration 2

Using the scenario above...

Discuss the ways in which charities differ from public listed companies and explain how these differences affect their respective governance structures. (9 marks)
Lecture 2 - Agency Theory
Illustration 1

Mary Hobbes joined the board of Rosh and Company, a large retailer, as finance director earlier this year. Whilst she was glad to have finally been given the chance to become finance director after several years as a financial accountant, she also quickly realised that the new appointment would offer her a lot of challenges. In the first board meeting, she realised that not only was she the only woman but she was also the youngest by many years.

Rosh was established almost 100 years ago. Members of the Rosh family have occupied senior board positions since the outset and even after the company’s flotation 20 years ago a member of the Rosh family has either been executive chairman or chief executive.

The current longstanding chairman, Timothy Rosh, has already prepared his slightly younger brother, Geoffrey (also a longstanding member of the board) to succeed him in two years’ time when he plans to retire. The Rosh family, who still own 40% of the shares, consider it their right to occupy the most senior positions in the company so have never been very active in external recruitment. They only appointed Mary because they felt they needed a qualified accountant on the board to deal with changes in international financial reporting standards.

Several former executive members have been recruited as non-executives immediately after they retired from full-time service. A recent death, however, has reduced the number of non-executive directors to two. These sit alongside an executive board of seven that, apart from Mary, have all been in post for over ten years.

Mary noted that board meetings very rarely contain any significant discussion of strategy and never involve any debate or disagreement. When she asked why this was, she was told that the directors had all known each other for so long that they knew how each other thought. All of the other directors came from similar backgrounds, she was told, and had worked for the company for so long that they all knew what was ‘best’ for the company in any given situation. Mary observed that notes on strategy were not presented at board meetings and she asked Timothy Rosh whether the existing board was fully equipped to formulate strategy in the changing world of retailing. She did not receive a reply.

Required:

(a) Explain ‘agency’ in the context of corporate governance and criticise the governance arrangements of Rosh and Company.  

(12 marks)
Lecture 4 - The Board
Illustration 1

KK is a large listed company. When a non-executive directorship of KK Limited became available, John Soria was nominated to fill the vacancy. John is the brother-in-law of KK’s chief executive Ken Kava. John is also the CEO of Soria Supplies Ltd, KK’s largest single supplier and is, therefore, very familiar with KK and its industry. He has sold goods to KK for over 20 years and is on friendly terms with all of the senior officers in the company. In fact last year, Soria Supplies appointed KK’s finance director, Susan Schwab, to a non-executive directorship on its board. The executive directors of KK all know and like John and so plan to ask the nominations committee to appoint him before the next AGM.

KK has recently undergone a period of rapid growth and has recently entered several new overseas markets, some of which, according to the finance director, are riskier than the domestic market. Ken Kava, being the dominant person on the KK board, has increased the risk exposure of the company according to some investors. They say that because most of the executive directors are less experienced, they rarely question his overseas expansion strategy. This expansion has also created a growth in employee numbers and an increase in the number of executive directors, mainly to manage the increasingly complex operations of the company. It was thought by some that the company lacked experience and knowledge of international markets as it expanded and that this increased the risk of the strategy’s failure. Some shareholders believed that the aggressive strategy, led by Ken Kava, has been careless as it has exposed KK Limited to some losses on overseas direct investments made before all necessary information on the investment was obtained.

As a large listed company, the governance of KK is important to its shareholders. Fin Brun is one of KK’s largest shareholders and holds a large portfolio of shares including 8% of the shares in KK. At the last AGM he complained to KK’s chief executive, Ken Kava, that he needed more information on directors’ performance. Fin said that he didn’t know how to vote on board reappointments because he had no information on how they had performed in their jobs. Mr Kava said that the board intended to include a corporate governance section in future annual reports to address this and to provide other information that shareholders had asked for. He added, however, that he would not be able to publish information on the performance of individual executive directors as this was too complicated and actually not the concern of shareholders. It was, he said, the performance of the board as a whole that was important and he (Mr Kava) would manage the performance targets of individual directors.

Required:

(a) Explain the term ‘conflict of interest’ in the context of non-executive directors and discuss the potential conflicts of interest relating to KK and Soria Supplies if John Soria were to become a non-executive director of KK Limited.

(8 marks)
Illustration 2

At a recent international meeting of business leaders, Seamus O’Brien said that multi-jurisdictional attempts to regulate corporate governance were futile because of differences in national culture. He drew particular attention to the Organisation for Economic Co-operation and Development (OECD) and International Corporate Governance Network (ICGN) codes, saying that they were, ‘silly attempts to harmonise practice’. He said that in some countries, for example, there were ‘family reasons’ for making the chairman and chief executive the same person. In other countries, he said, the separation of these roles seemed to work. Another delegate, Alliya Yongvanich, said that the roles of chief executive and chairman should always be separated because of what she called ‘accountability to shareholders’.

One delegate, Vincent Viola, said that the right approach was to allow each country to set up its own corporate governance provisions. He said that it was suitable for some countries to produce and abide by their own ‘very structured’ corporate governance provisions, but in some other parts of the world, the local culture was to allow what he called, ‘local interpretation of the rules’. He said that some cultures valued highly structured governance systems while others do not care as much.

Required:

(a) Explain the roles of the chairman in corporate governance. (5 marks)

(b) Assess the benefits of the separation of the roles of chief executive and chairman that Alliya Yongvanich argued for and explain her belief that ‘accountability to shareholders’ is increased by the separation of these roles. (12 marks)
Lecture 5 - Directors & Committees
Illustration 1

Sam Mesentery was appointed a director of Ding Company in October this year taking on the role of financial controller. He had moved himself and his family to a new country to take up the post and was looking forward to the new challenges. When he arrived he learned that he was on the ‘operating board’ of Ding Company and that there was a ‘corporate board’ above the operating board that was senior to it. This surprised him as in the companies he had worked for in his own country, all directors in the company were equal. The corporate board at Ding was small, with five directors in total, while the operating board was larger, with ten members.

After a few days in the job he received an e-mail requiring him to report to Annette Hora, the managing director. She said that she had regretfully received two complaints from another senior colleague about Sam’s behaviour. First, Sam had apparently made a highly inappropriate remark to a young female colleague and second, his office was laid out in the wrong way. Not only was his desk positioned in breach of fire regulations but also, he was told that it was normal to have the desk facing towards the door so that colleagues felt more welcomed when they went in. ‘It’s company policy’ she said abruptly. Sam remembered the conversation with the young female colleague but was unaware of anything inappropriate in what he had said to her. He said that he positioned his desk so he could get the best view out of the window when he was working.

The following day he arrived at work to find that the corporate board was in an emergency meeting. There had been a sudden and dramatic change in the circumstances of one of Ding’s major suppliers and the corporate board later said that they needed to meet to agree a way forward and a strategy to cope with the change. Annette said that because of the competitive nature of its resource markets, Ding had to act fast and preferably before its competitors. Hence the necessity of a two-tier board structure. She said there was no time for lengthy discussions which was why the operating board was excluded. Sam was told that Ding operated in a ‘complex and turbulent’ environment and when strategic factors in the environment changed, the company often had to respond quickly and decisively.

It was a month later that Sam first met with Arif Zaman, Ding’s non-executive chairman. After Arif asked Sam how he was settling in, Sam asked Arif why he preferred a two-tier board structure and Arif replied that actually it was Annette’s idea. He said that she prefers it that way and because he is a non-executive member doesn’t feel able to challenge her opinion on it. Because ‘it seems to work’ he had no plans to discuss it with her. He went on to say that he was an old friend of Annette’s and was only in post to satisfy the corporate governance requirements to have a non-executive chairman. He said that he saw his role as mainly ceremonial and saw no need to take any direct interest in the company’s activities. He said that he chaired some board meetings when he was available and he sometimes wrote the chairman’s statement in the annual report.

Required:

Explain the content of a director’s induction programme and assess the advantages of such a programme for Sam.

(8 marks)
Illustration 2

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Required:

Define ‘retirement by rotation’ and explain its importance in the context of Rosh and Company.

(5 marks)

Illustration 3

Using the scenario in Illustration 2...

Explain the roles of a nominations committee and assess the potential usefulness of a nominations committee to the board of Rosh and Company.

(8 marks)
Lecture 6 - Directors
Remuneration
Illustration 1

Five years ago, George Woof was appointed chief executive officer (CEO) of Tomato Bank, one of the largest global banks. Mr Woof had a successful track record in senior management in America and his appointment was considered very fortunate for the company. Analysts rated him as one of the world’s best bankers and the other directors of Tomato Bank looked forward to his appointment and a significant strengthening of the business.

One of the factors needed to secure Mr Woof’s services was his reward package. Prior to his acceptance of the position, Tomato Bank’s remuneration committee (comprised entirely of non-executives) received a letter from Mr Woof saying that because his track record was so strong, they could be assured of many years of sustained growth under his leadership. In discussions concerning his pension, however, he asked for a generous non-performance related pension settlement to be written into his contract so that it would be payable whenever he decided to leave the company (subject to a minimum term of two years) and regardless of his performance as CEO. Such was the euphoria about his appointment that his request was approved. Furthermore in the hasty manner in which Mr Woof’s reward package was agreed, the split of his package between basic and performance-related components was not carefully scrutinised. Everybody on the remuneration committee was so certain that he would bring success to Tomato Bank that the individual details of his reward package were not considered important.

In addition, the remuneration committee received several letters from Tomato Bank’s finance director, John Temba, saying, in direct terms, that they should offer Mr Woof ‘whatever he wants’ to ensure that he joins the company and that the balance of benefits was not important as long as he joined. Two of the non-executive directors on the remuneration committee were former colleagues of Mr Woof and told the finance director they would take his advice and make sure they put a package together that would ensure Mr Woof joined the company.

Once in post, Mr Woof led an excessively aggressive strategy that involved high growth in the loan and mortgage books financed from a range of sources, some of which proved unreliable. In the fifth year of his appointment, the failure of some of the sources of funds upon which the growth of the bank was based led to severe financing difficulties at Tomato Bank. Shareholders voted to replace George Woof as CEO. They said he had been reckless in exposing the company to so much risk in growing the loan book without adequately covering it with reliable sources of funds.

When he left, the press reported that despite his failure in the job, he would be leaving with what the newspapers referred to as an ‘obscenely large’ pension. Some shareholders were angry and said that Mr Woof was being ‘rewarded for failure’. When Mr Woof was asked if he might voluntarily forego some of his pension in recognition of his failure in the job, he refused, saying that he was contractually entitled to it and so would be keeping it all.

Required:

Criticise the performance of Tomato Bank’s remuneration committee in agreeing Mr Woof’s reward package.  

(10 marks)
Illustration 2

Using the scenario in Illustration 1...

Required:

Describe the components of an appropriately designed executive reward package and explain why a more balanced package of benefits should have been used to reward Mr Woof.

(10 marks)
Lecture 7 - Shareholders Relations
Illustration 1

In the 2009 results presentation to analysts, the chief executive of ZPT, a global internet communications company, announced an excellent set of results to the waiting audience. Chief executive Clive Xu announced that, compared to 2008, sales had increased by 50%, profits by 100% and total assets by 80%. The dividend was to be doubled from the previous year. He also announced that based on their outstanding performance, the executive directors would be paid large bonuses in line with their contracts. His own bonus as chief executive would be $20 million. When one of the analysts asked if the bonus was excessive, Mr Xu reminded the audience that the share price had risen 45% over the course of the year because of his efforts in skilfully guiding the company. He said that he expected the share price to rise further on the results announcement, which it duly did. Because the results exceeded market expectation, the share price rose another 25% to $52.

Three months later, Clive Xu called a press conference to announce a restatement of the 2009 results. This was necessary, he said, because of some ‘regrettable accounting errors’. This followed a meeting between ZPT and the legal authorities who were investigating a possible fraud at ZPT. He disclosed that in fact the figures for 2009 were increases of 10% for sales, 20% for profits and 15% for total assets which were all significantly below market expectations. The proposed dividend would now only be a modest 10% more than last year. He said that he expected a market reaction to the restatement but hoped that it would only be a short-term effect.

The first questioner from the audience asked why the auditors had not spotted and corrected the fundamental accounting errors and the second questioner asked whether such a disparity between initial and restated results was due to fraud rather than ‘accounting errors’. When a journalist asked Clive Xu if he intended to pay back the $20 million bonus that had been based on the previous results, Mr Xu said he did not. The share price fell dramatically upon the restatement announcement and, because ZPT was such a large company, it made headlines in the business pages in many countries.

Later that month, the company announced that following an internal investigation, there would be further restatements, all dramatically downwards, for the years 2006 and 2007. This caused another mass selling of ZPT shares resulting in a final share value the following day of $1. This represented a loss of shareholder value of $12 billion from the peak share price. Clive Xu resigned and the government regulator for business ordered an investigation into what had happened at ZPT. The shares were suspended by the stock exchange. A month later, having failed to gain protection from its creditors in the courts, ZPT was declared bankrupt. Nothing was paid out to shareholders whilst suppliers received a fraction of the amounts due to them. Some non-current assets were acquired by competitors but all of ZPT’s 54,000 employees lost their jobs, mostly with little or no termination payment. Because the ZPT employees’ pension fund was not protected from creditors, the value of that was also severely reduced to pay debts which meant that employees with many years of service would have a greatly reduced pension to rely on in old age.

Because ZPT was regarded for many years as a high performing company in a growing market, many institutional investors had increased the number of ZPT shares in their investment portfolios. When the share price lost its value, it meant that the overall value of their funds was reduced and some individual shareholders demanded to know why the
institutional investors had not intervened sooner to either find out what was really going on in ZPT or divest ZPT shares. Some were especially angry that even after the first restatement was announced, the institutional investors did not make any attempt to intervene. One small investor said he wanted to see more ‘shareholder activism’, especially among the large institutional investors.

Some time later, Mr Xu argued that one of the reasons for the development of the complex ZPT business model was that it was thought to be necessary to manage the many risks that ZPT faced in its complex and turbulent business environment. He said that a multiplicity of overseas offices was necessary to address exchange rate risks, a belief challenged by some observers who said it was just to enable the ZPT board to make their internal controls and risk management less transparent.

Because of their large shareholdings, institutional investors are sometimes able to intervene directly in the companies they hold shares in.

Required:

(i) Explain the factors that might lead institutional investors to attempt to intervene directly in the management of a company;

(ii) Construct the case for institutional investors attempting to intervene in ZPT after the first results restatement was announced.
Lecture 8 - Approaches to Corporate Governance
Illustration 1

There has been a debate in the country of Geeland for some years about the most appropriate way to regulate corporate governance. Several years ago, there were a number of major corporate failures and 'scandals' caused in part by a number of single powerful individuals dominating their boards. Business leaders and policy-makers were sceptical about a rules-based approach, and this led the Geeland stock exchange to issue guidance in the 'Geeland Code' as follows:

‘Good corporate governance is not just a matter of prescribing particular corporate structures and complying with a number of rules. There is a need for broad principles. All stakeholders should then apply these flexibly to the varying circumstances of individual companies.’

Given the causes of the Geeland corporate governance failures, there was a debate about whether the separation of the roles of chairman and chief executive should be made a legal requirement. This resulted in the stock exchange issuing guidance that whilst a rules-based or ‘box ticking’ approach would specify that ‘the roles of chairman and chief executive officer should never be combined... We do not think that there are universally valid answers on such points.’

One company to take advantage of the flexibility in Geeland’s principles-based approach was Anson Company. In July 2010, Anson Company announced that it had combined its roles of chairman and chief executive in a single role carried out by one individual. In accordance with the Geeland listing rules, it made the following ‘comply or explain’ statement in its 2011 annual report:

‘Throughout the year the company complied with all Geeland Code provisions with the exception that from 1 July 2010 the roles of chairman and chief executive have been exercised by the same individual, William Klunker. We recognise that this has been out of line with best practice. We understand the concerns of shareholders but believe that we have maintained robust governance while at the same time benefiting from having Mr Klunker in control. On 31 July 2012 Mr Klunker will step down as executive chairman, remaining as chairman until we conclude our search for a non-executive chairman to succeed him, no later than March 2013.’

Required:

(a) Briefly distinguish between rules and principles-based approaches to corporate governance. Critically evaluate the Geeland stock exchange’s guidance that ‘all stakeholders should then apply these flexibly to the varying circumstances of individual companies.’

(b) Assess the ‘comply or explain’ statement made by Anson Company in its 2011 annual report.
Lecture 9 - Corporate Social Responsibility
Illustration 1

When a prominent football club, whose shares were listed, announced that it was to build a new stadium on land near to its old stadium, opinion was divided. Many of the club’s fans thought it a good idea because it would be more comfortable for them when watching games.

A number of problems arose, however, when it was pointed out that the construction of the new stadium and its car parking would have a number of local implications. The local government authority said that building the stadium would involve diverting roads and changing local traffic flow, but that it would grant permission to build the stadium if those issues could be successfully addressed.

A number of nearby residents complained that the new stadium would be too near their homes and that it would destroy the view from their gardens. Helen Yusri, who spoke on behalf of the local residents, said that the residents would fight the planning application through legal means if necessary. A nearby local inner-city wildlife reservation centre said that the stadium’s construction might impact on local water levels and therefore upset the delicate balance of animals and plants in the wildlife centre. A local school, whose pupils often visited the wildlife centre, joined in the opposition, saying that whilst the school supported the building of a new stadium in principle, it had concerns about disruption to the wildlife centre.

The football club’s board was alarmed by the opposition to its planned new stadium as it had assumed that it would be welcomed because the club had always considered itself a part of the local community. The club chairman said that he wanted to maintain good relations with all local people if possible, but at the same time he owed it to the fans and the club’s investors to proceed with the building of the new stadium despite local concerns.

Required:

(a) Define ‘stakeholder’ and explain the importance of identifying all the stakeholders in the stadium project.

(10 marks)
Lecture 10 - Internal Controls
Illustration 1

Describe FIVE general objectives of internal control. (5 marks)
Lecture 11 - Audit I - Audit Committee
Illustration 1

Susan Paullaos was recently appointed as a non-executive member of the internal audit committee of Gluck and Goodman, a public listed company producing complex engineering products. Barney Chester, the executive finance director who chairs the committee, has always viewed the purpose of internal audit as primarily financial in nature and as long as financial controls are seen to be fully in place, he is less concerned with other aspects of internal control.

When Susan asked about operational controls in the production facility Barney said that these were not the concern of the internal audit committee. This, he said, was because as long as the accounting systems and financial controls were fully functional, all other systems may be assumed to be working correctly.

Susan, however, was concerned with the operational and quality controls in the production facility. She spoke to production director Aaron Hardanger, and asked if he would be prepared to produce regular reports for the internal audit committee on levels of specification compliance and other control issues. Mr Hardanger said that the internal audit committee had always trusted him because his reputation as a manager was very good. He said that he had never been asked to provide compliance evidence to the internal audit committee and saw no reason as to why he should start doing so now.

At board level, the non-executive chairman, George Allejandra, said that he only instituted the internal audit committee in the first place in order to be seen to be in compliance with the stock market’s requirement that Gluck and Goodman should have one. He believed that internal audit committees didn’t add materially to the company. They were, he believed, one of those ‘outrageous demands’ that regulatory authorities made without considering the consequences in smaller companies nor the individual needs of different companies. He also complained about the need to have an internal auditor. He said that Gluck and Goodman used to have a full time internal auditor but when he left a year ago, he wasn’t replaced. The audit committee didn’t feel it needed an internal auditor because Barney Chester believed that only financial control information was important and he could get that information from his management accountant.

Susan asked Mr Allejandra if he recognised that the company was exposing itself to increased market risks by failing to have an effective audit committee. Mr Allejandra said he didn’t know what a market risk was.

Required:

Internal control and audit are considered to be important parts of sound corporate governance.

Criticise the internal control and internal audit arrangements at Gluck and Goodman as described in the case scenario. 

(10 marks)
Lecture 13 - Ethical Code
Illustration 1

The IFAC code of professional ethics (2009), adopted as being relevant to ACCA members and students, contains the following advice.

‘A professional accountant in business or an immediate or close family member may be offered an inducement. Inducements may take various forms, including gifts, hospitality, preferential treatment, and inappropriate appeals to friendship or loyalty. Offers of inducements may create threats to compliance with the fundamental principles [of professionalism].’

Executive director and qualified accountant Ann Koo was in charge of awarding large outsourcing contracts for a large public listed company. When her family fell into debt, she looked for a way to make some additional income. When her company was seeking to place a contract for a large outsourced service, without inviting other tenders from which to select, she accepted a bid from one supplier who said it would pay her $50,000 as a ‘thank you’ once the contract was awarded.

She justified her behaviour by reminding herself that she obtained her job partly because she was an accountant and that she had worked extremely hard to obtain her accounting qualification. She believed she was entitled to make a ‘higher personal return’ on her investment of time and effort in her accountancy training and through successful qualification as a professional accountant.

Required:
(a) Briefly describe the five types of ethical threats in the IFAC code of professional ethics (2009) and discuss how accepting excessive ‘gifts’ or ‘hospitality’ can give rise to some of these threats within this case. (9 marks)

(b) Criticise Ann Koo’s beliefs and behaviour, and explain why accepting the $50,000 conflicts with her duty to uphold the public interest. (10 marks)
Lecture 14 - Risk Management I
Illustration 1

During the global economic recession that began in mid 2008, many companies found it difficult to gain enough credit in the form of short-term loans from their banks and other lenders. In some cases, this caused working capital problems as short-term cash flow deficits could not be funded.

Ultra-Uber Limited (UU), a large manufacturer based in an economically depressed region, had traditionally operated a voluntary supplier payment policy in which it was announced that all trade payables would be paid at or before 20 days and there would be no late payment. This was operated despite the normal payment terms being 30 days. The company gave the reason for this as ‘a desire to publicly demonstrate our social responsibility and support our valued suppliers, most of whom, like UU, also provide employment in this region’.

In the 20 years the policy had been in place, the UU website proudly boasted that it had never been broken. Brian Mills, the chief executive often mentioned this as the basis of the company’s social responsibility. ‘Rather than trying to delay our payments to suppliers,’ he often said, ‘we support them and their cash flow. It’s the right thing to do.’ Most of the other directors, however, especially the finance director, think that the voluntary supplier payment policy is a mistake. Some say that it is a means of Brian Mills exercising his own ethical beliefs in a way that is not supported by others at UU Limited.

When UU itself came under severe cash flow pressure in the summer of 2009 as a result of its bank’s failure to extend credit, the finance director told Brian Mills that UU’s liquidity problems would be greatly relieved if they took an average of 30 rather than the 20 days to pay suppliers.

In addition, the manufacturing director said that he could offer another reason why the short-term liquidity at UU was a problem. He said that the credit control department was poor, taking approximately 50 days to receive payment from each customer. He also said that his own inventory control could be improved and he said he would look into that. It was pointed out to the manufacturing director that cost of goods sold was 65% of turnover and this proportion was continuously rising, driving down gross and profit margins. Due to poor inventory controls, excessively high levels of inventory were held in store at all stages of production. The long-serving sales manager wanted to keep high levels of finished goods so that customers could buy from existing inventory and the manufacturing director wanted to keep high levels of raw materials and work-in-progress to give him minimum response times when a new order came in.

One of the non-executive directors (NEDs) of UU Limited, Bob Ndumo, said that he could not work out why UU was in such a situation as no other company in which he was a NED was having liquidity problems. Bob Ndumo held a number of other NED positions but these were mainly in service-based companies.

Required:

(i) Define ‘risk embeddedness’ and explain the methods by which risk awareness and management can be embedded in organisations. (7 marks)

(ii) Examine the obstacles to embedding liquidity risk management at UU Limited. (8 marks)
Illustration 2

Using the scenario in Illustration 1...

Define ‘liquidity risk’ and explain why it might be a significant risk to UU Limited.

(5 marks)
Lecture 15 - Risk Management II
Illustration 1

The board of YGT discussed its need for timely risk information. The consensus of the meeting was that risk consultants should be engaged to review the risks facing the company. One director, Raz Dutta, said that she felt that this would be a waste of money as the company needed to concentrate its resources on improving organisational efficiency rather than on gathering risk information. She said that many risks ‘didn’t change much’ and ‘hardly ever materialised’ and so can mostly be ignored. The rest of the board, however, believed that a number of risks had recently emerged whilst others had become less important and so the board wanted a current assessment as it believed previous assessments might now be outdated.

The team of risk consultants completed the risk audit. They identified and assessed six potential risks (A, B, C, D, E and F) and the following information was discussed when the findings were presented to the YGT board:

Risk A was assessed as unlikely and low impact whilst Risk B was assessed as highly likely to occur and with a high impact. The activities giving rise to both A and B, however, are seen as marginal in that whilst the activities do have value and are capable of making good returns, neither is strategically vital.

Risk C was assessed as low probability but with a high potential impact and also arises from an activity that must not be discontinued although alternative arrangements for bearing the risks are possible. The activity giving rise to Risk C was recently introduced by YGT as a result of a new product launch.

Risk D was assessed as highly likely but with a low potential impact, and arose as a result of a recent change in legislation. It cannot be insured against nor can it be outsourced. It is strategically important that the company continues to engage in the activity that gives rise to Risk D although not necessarily at the same level as is currently the case.

In addition, Risks E and F were identified. Risk E was an environmental risk and Risk F was classed as a reputation risk. The risk consultants said that risks E and F could be related risks. In the formal feedback to the board of YGT, the consultants said that the company had to develop a culture of risk awareness and that this should permeate all levels of the company.

**Required:**

(a) Criticise Raz Dutta’s beliefs about the need for risk assessment. Explain why risks are dynamic and therefore need to be assessed regularly.  
(8 marks)

(b) Using the TARA framework, select and explain the appropriate strategy for managing each risk (A, B, C and D). Justify your selection in each case.  
(6 marks)
Illustration 2

Using the scenario in Illustration 1...

Explain what ‘related risks’ are and describe how Risks E and F might be positively correlated.

(5 marks)
Lecture 16 - Ethical Theories
Illustration 1

It was the final day of a two-week-long audit of Van Buren Company, a longstanding client of Fillmore Pierce Auditors. In the afternoon, Anne Hayes, a recently qualified accountant and member of the audit team, was following an audit trail on some cash payments when she discovered what she described to the audit partner, Zachary Lincoln, as an ‘irregularity’. A large and material cash payment had been recorded with no recipient named. The corresponding invoice was handwritten on a scrap of paper and the signature was illegible.

Zachary, the audit partner, was under pressure to finish the audit that afternoon. He advised Anne to seek an explanation from Frank Monroe, the client’s finance director. Zachary told her that Van Buren was a longstanding client of Fillmore Pierce and he would be surprised if there was anything unethical or illegal about the payment. He said that he had personally been involved in the Van Buren audit for the last eight years and that it had always been without incident. He also said that Frank Monroe was an old friend of his from university days and that he was certain that he wouldn’t approve anything unethical or illegal. Zachary said that Fillmore Pierce had also done some consultancy for Van Buren so it was a very important client that he didn’t want Anne to upset with unwelcome and uncomfortable questioning.

When Anne sought an explanation from Mr Monroe, she was told that nobody could remember what the payment was for but that she had to recognise that ‘real’ audits were sometimes a bit messy and that not all audit trails would end as she might like them to. He also reminded her that it was the final day and both he and the audit firm were under time pressure to conclude business and get the audit signed off.

When Anne told Zachary what Frank had said, Zachary agreed not to get the audit signed off without Anne’s support, but warned her that she should be very certain that the irregularity was worth delaying the signoff for. It was therefore now Anne’s decision whether to extend the audit or have it signed off by the end of Friday afternoon.

Anne is experiencing some tension due to the conflict between her duties and responsibilities as an employee of Fillmore Pierce and as a qualified professional accountant.

Required:

(i) Explain the ethical tensions between her role as an employee and a professional accountant that Anne is now experiencing.  

(4 marks)

(ii) Explain how absolutist (dogmatic) and relativist (pragmatic) ethical assumptions would affect the outcome of Anne’s decision.  

(6 marks)
Illustration 2

When a prominent football club, whose shares were listed, announced that it was to build a new stadium on land near to its old stadium, opinion was divided. Many of the club's fans thought it a good idea because it would be more comfortable for them when watching games. A number of problems arose, however, when it was pointed out that the construction of the new stadium and its car parking would have a number of local implications. The local government authority said that building the stadium would involve diverting roads and changing local traffic flow, but that it would grant permission to build the stadium if those issues could be successfully addressed.

A number of nearby residents complained that the new stadium would be too near their homes and that it would destroy the view from their gardens. Helen Yusri, who spoke on behalf of the local residents, said that the residents would fight the planning application through legal means if necessary. A nearby local inner-city wildlife reservation centre said that the stadium’s construction might impact on local water levels and therefore upset the delicate balance of animals and plants in the wildlife centre. A local school, whose pupils often visited the wildlife centre, joined in the opposition, saying that whilst the school supported the building of a new stadium in principle, it had concerns about disruption to the wildlife centre.

The football club’s board was alarmed by the opposition to its planned new stadium as it had assumed that it would be welcomed because the club had always considered itself a part of the local community. The club chairman said that he wanted to maintain good relations with all local people if possible, but at the same time he owed it to the fans and the club’s investors to proceed with the building of the new stadium despite local concerns.

Required:

Compare and contrast Gray, Owen and Adams’s ‘pristine capitalist’ position with the ‘social contractarian’ position. Explain how these positions would affect responses to stakeholder concerns in the new stadium project.

(8 marks)
Lecture 17 - Ethical Behaviour
Hogg Products Company (HPC), based in a developing country, was recently wholly acquired by American Overseas Investments (AOI), a North American holding company. The new owners took the opportunity to completely review HPC’s management, culture and systems. One of the first things that AOI questioned was HPC’s longstanding corporate code of ethics.

The board of AOI said that it had a general code of ethics that HPC, as an AOI subsidiary, should adopt. Simon Hogg, the chief executive of HPC, disagreed however, and explained why HPC should retain its existing code. He said that HPC had adopted its code of ethics in its home country which was often criticised for its unethical business behaviour. Some other companies in the country were criticised for their ‘sweat shop’ conditions. HPC’s adoption of its code of ethics, however, meant that it could always obtain orders from European customers on the guarantee that products were made ethically and in compliance with its own highly regarded code of ethics. Mr Hogg explained that HPC had an outstanding ethical reputation both locally and internationally and that reputation could be threatened if it was forced to replace its existing code of ethics with AOI’s more general code.

When Ed Tanner, a senior director from AOI’s head office, visited Mr Hogg after the acquisition, he was shown HPC’s operation in action. Mr Hogg pointed out that unlike some other employers in the industry, HPC didn’t employ child labour. Mr Hogg explained that although it was allowed by law in the country, it was forbidden by HPC’s code of ethics. Mr Hogg also explained that in his view, employing child labour was always ethically wrong. Mr Tanner asked whether the money that children earned by working in the relatively safe conditions at HPC was an important source of income for their families.

Mr Hogg said that the money was important to them but even so, it was still wrong to employ children, as it was exploitative and interfered with their education. He also said that it would alienate the European customers who bought from HPC partly on the basis of the terms of its code of ethics.

Required:

(a) Describe the purposes and typical contents of a corporate code of ethics. (9 marks)

(b) ‘Strategic positioning’ is about the way that a company as a whole is placed in its environment and concerns its ‘fit’ with the factors in its environment. With reference to the case as appropriate, explain how a code of ethics can be used as part of a company’s overall strategic positioning. (7 marks)

(c) Assess Mr Hogg’s belief that employing child labour is ‘always ethically wrong’ from deontological and teleological (consequentialist) ethical perspectives. (9 marks)
Lecture 18 - Ethical Behaviour II
Illustration 1

The Mary Jane was a large passenger and vehicle ferry operating between the two major ports of Eastport and Northport across a busy section of ocean known as the 'Northport route'. Prior to this, the Mary Jane had operated for many years in the much calmer waters of the 'Southsea route' but she had been transferred to the Northport route because her large size meant that more profit could be made by carrying more passengers and vehicles per journey. She was capable of carrying up to 1,000 passengers, 300 cars and 100 lorries per trip. The Mary Jane belonged to Sea Ships Company, a long established international company with a fleet of five ships operating on routes in other parts of the world. The Mary Jane had large doors at both the front and rear. Vehicles would drive in through the rear doors in Eastport and when she arrived in Northport, the Mary Jane would dock the other way round so that the vehicles could drive straight out using the forward doors. There were two doors at each end, upper and lower, and it was important that all four doors were securely closed before setting out to sea.

As with all marine operations, the safety procedures aboard the Mary Jane were subject to regulation, but her design left one weakness which was eventually to prove a disaster. From the main control bridge of the ship, it was not possible to see the front or rear doors, which meant that it wasn’t possible to check from the main control bridge that they were closed upon departure from a port. On the night of 7 November, the Mary Jane was leaving Eastport in a storm for a crossing to Northport, a journey which should have taken five hours. It was dark and the weather was very poor. When she was only a few kilometres out from the Eastport harbour, water entered the car decks through the upper rear doors that had been left open after the Mary Jane had left port.

The stormy conditions meant that the waves were very high and on this occasion, high enough so that when a large wave hit, the water entered through the open rear doors. Once enough water had entered her car decks, the Mary Jane began to lean to 30 degrees before completely falling over onto her side. The speed of the event, less than two minutes, meant that escape via lifeboats wasn’t possible and the Mary Jane sank with the loss of many lives.

Among the survivors was first officer Ned Prop. Mr Prop later told how a recent change to staff reporting procedures had produced a situation in which the responsibility for checking that the rear doors were closed before sailing had changed. He said that, under the new system, two people were responsible for safety on the car deck but each person assumed that the other had checked that the upper rear doors had been closed. A reporting system in which each department head (car deck, navigation, etc.) on the ship separately reported readiness for sea to the captain at the beginning of each journey had been abandoned because it was too inconvenient to operate. Mr Prop said that the normal procedure was that if they didn’t hear anything to the contrary by the departure time, he and Captain Mullet assumed that all was well throughout the ship and they could put to sea.

Mr Prop told how procedures on board ship often relied on ‘human teamwork’ rather than ‘following paperwork systems’. It also emerged that, on the day of the disaster, a mistake in loading vehicles onto the wrong decks had delayed the ship’s departure and created pressure to leave as soon as possible after all the vehicles were loaded. Mr Prop said that this too may have been a contributory factor to the confusion over who should have checked that the rear doors were closed. Mr Prop’s superior officer, Captain Mullet, was drowned in the disaster.
Sea Ships Company, the Mary Jane’s owner, was one of the longest established and most respected companies listed on the stock exchange. Although best known for its ferry operations, it had diversified into other activities in recent years. It was considered by investment analysts to be a ‘steady and reliable’ investment and the company chief executive, Wim Bock, had often said that Sea Ships Company employed ‘the highest standards of corporate ethics’. It also valued its reputation as a well-run company and believed that the company’s value was primarily due to its reputation for ‘outstanding customer care’. The board often claimed that Sea Ships was a socially responsible company.

When Sea Ships’ board met to discuss how to proceed after the disaster, Wim Bock said that the company could expect to receive substantial claims from victims’ relatives. He also reported that, because of a regrettable oversight in the company’s legal department, only a proportion of that liability would be covered by the company’s insurance. There would also be punitive fines from the courts, the size of which would, a legal advisor said, reflect the scale of Sea Ship’s negligence in contributing to the disaster. The finance director, Jill Wha, reported that if the company met the expected uninsured liabilities in full, even if reduced on appeal, it would severely threaten future cash flows as it would most likely have to sell non-current assets (most of its ships) to settle the claims. If large punitive fines were also imposed after the legal process, Mr Bock said that the company may not survive.

The government ordered an enquiry and a senior official was appointed to investigate the disaster. In her conclusions, enquiry chairman Caroline Chan said that in addition to the human error in not ensuring that the upper rear doors had been closed, it had also emerged that the Mary Jane had been travelling above the local shipping speed limit out of Eastport harbour. The excess speed had caused increased turbulence in the water and this was made much worse by the storm on the night in question. The combination of these factors meant that water gradually entered the open upper rear doors and this eventually caused the ship to lean and then capsize. Mrs Chan said that contrary to the board’s perception of itself as a well-run company, she had encountered a ‘culture of carelessness’ at Sea Ships and that the internal control systems were inadequate for safely operating a fleet of ships. She reserved particular criticism for the board of Sea Ships saying that it was unbalanced, lacked independent scrutiny and, because none of the existing directors had ever served on board a ship, lacked representation from technically qualified nautical officers.

After the enquiry was concluded, but before the level of claims and punitive damages had been set by the courts, a document emerged within the company confirming that certain independent advice had been received from an external consultant. The advice was received at the time of the Mary Jane’s transfer from the Southsea route to the Northport route. Because the Northport route is a much rougher area of sea, the advice concerned structural changes to the Mary Jane that would make her safer in rougher seas. Had the advice been followed, the Mary Jane would have had additional doors inserted inside the car deck to act as a second internal bulkhead to prevent water flooding the whole deck. Water would still have entered through the open rear doors on the night of 7 November, but would have been kept sealed in that rear section of the car deck and the Mary Jane would not have sunk. The company had received the advice but had not acted upon it as it would have required an expensive refit for the Mary Jane. This advice was then ‘lost’ in the company and only emerged later on.
Required:

The independent consultant’s advice was that the Mary Jane should have received structural work to make her safe for operating in the rougher seas of the Northport route. Sea Ships Company did not act on the advice.

Using the seven-step American Accounting Association (AAA) model for ethical decision-making, examine the company’s dilemma on whether or not to disclose this information publicly.

(14 marks)
Lecture 19 - Social & Environmental Accounting
Illustration 1

At a board meeting of JGP Chemicals Limited, the directors were discussing some recent negative publicity arising from the accidental emission of a chemical pollutant into the local river. As well as it resulting in a large fine from the courts, the leak had created a great deal of controversy in the local community that relied on the polluted river for its normal use (including drinking). A prominent community leader spoke for those affected when she said that a leak of this type must never happen again or JGP would suffer the loss of support from the community. She also reminded JGP that it attracts 65% of its labour from the local community.

As a response to the problems that arose after the leak, the JGP board decided to consult an expert on whether the publication of a full annual environmental report might help to mitigate future environmental risks. The expert, Professor Appo (a prominent academic), said that the company would need to establish an annual environmental audit before they could issue a report. He said that the environmental audit should include, in addition to a review and evaluation of JGP’s safety controls, a full audit of the environmental impact of JGP’s supply chain. He said that these components would be very important in addressing the concerns of a growing group of investors who are worried about such things. Professor Appo said that all chemical companies had a structural environmental risk and JGP was no exception to this. As major consumers of natural chemical resources and producers of potentially hazardous outputs, Professor Appo said that chemical companies should be aware of the wide range of ways in which they can affect the environment. CEO Keith Miasma agreed with Professor Appo and added that because JGP was in chemicals, any environmental issue had the potential to affect JGP’s overall reputation among a wide range of stakeholders.

When the board was discussing the issue of sustainability in connection with the environmental audit, the finance director said that sustainability reporting would not be necessary as the company was already sustainable because it had no ‘going concern’ issues. He said that JGP had been in business for over 50 years, should be able to continue for many years to come and was therefore sustainable. As far as he was concerned, this was all that was meant by sustainability.

In the discussion that followed, the board noted that in order to signal its seriousness to the local community and to investors, the environmental audit should be as thorough as possible and that as much information should be made available to the public ‘in the interests of transparency’. It was agreed that contents of the audit (the agreed metrics) should be robust and with little room left for interpretation – they wanted to be able to demonstrate that they had complied with their agreed metrics for the environmental audit.

Required:

Explain ‘sustainability’ in the context of environmental auditing and criticise the finance director’s understanding of sustainability.  

(6 marks)
Illustration 2

Using the scenario from Illustration 1...

Define ‘environmental risk’. Distinguish between strategic and operational risks and explain why the environmental risks at JGP are strategic.

(10 marks)

Illustration 3

Using the scenario in Illustration 1...

Explain the three stages in an environmental audit and explore, using information from the case, the issues that JGP will have in developing these stages.

(9 marks)