Professional Level – Essentials Module

Governance, Risk and Ethics

Monday 13 June 2011

Paper P1

Time allowed
Reading and planning: 15 minutes
Writing: 3 hours

This paper is divided into two sections:

Section A – This ONE question is compulsory and MUST be attempted

Section B – TWO questions ONLY to be attempted

Do NOT open this paper until instructed by the supervisor.
During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.
This question paper must not be removed from the examination hall.

The Association of Chartered Certified Accountants

ACCA

Section A – This ONE question is compulsory and MUST be attempted

1 The Bobo car company decided to launch a new model of car to compete in the highly competitive 'economy' market. Although Bobo was a long-established and profitable car manufacturer with a wide range of vehicles in other markets (such as family cars, four-wheel drives, etc), it had not entered the economy market because it believed profit margins would be too low. Company research showed that this was the car market segment with the smallest unit profits. The appointment of James Tsakos as chief executive changed that, however, as he believed that Bobo should offer a model in every category of car. It was announced that the new economy car, when launched, would be called the 'Bobo Foo'. The key concepts in the new model were conveyed to the design team led by executive director and head of design, Kathy Yao: cheap to buy, economical to run, cheap to repair, easy to park, fun to drive.

At the outset, James Tsakos met to discuss the new model with Kathy Yao. Because it was to enter the economy market, the minimisation of unit costs would be absolutely paramount. Mr Tsakos had some posters printed to hang in the design offices that read: 'The Bobo Foo – keep it cheap!' They were all signed personally by Mr Tsakos to emphasise the message to the design team as they were designing the car.

As well as repeating the 'Keep it cheap' message as often as possible, Mr Tsakos also instructed Kathy Yao that rather than the usual 43 months it took to develop a new model of car 'from the drawing board to the road', he wanted the Bobo Foo ready in 25 months. This, again, was about saving on costs to increase the eventual unit profits once the Bobo Foo was on sale. The design team was placed under a lot of pressure by Mr Tsakos, and Kathy Yao became stressed with the demand to complete the project in such a short time period. She privately told colleagues that the period was too short to ensure that all design features were safety tested. (This case took place before rigid safety regulations were imposed by governments so legal issues can be ignored.)

Kathy Yao's team worked out that one way of reducing manufacturing costs would be to position the car's fuel tank slightly differently from usual. She calculated that a small amount could be saved on producing each unit of production if the fuel tank was placed behind the rear axle rather that on top of the axle as was the normal practice. Along with other cost saving measures, this was incorporated into the finished prototype. In order to shorten the time to market, the factory started to be prepared for production of the Bobo Foo (called 'tooling up') as soon as the completed design was available but before the prototype was fully tested.

When the prototype Bobo Foo went through a range of crash tests, the positioning of the fuel tank was shown to be a potential fire risk in the event of a rear collision. No action was taken in the light of this observation because, as part of the low-cost strategy for the Bobo Foo, the factory had already been tooled up and was ready to begin production. The board decided that it would have been too expensive to retool the production line to a modified design and so it went into production as it was.

The Bobo Foo quickly became a big seller and sold half a million units of the model a year, making it appear that the Bobo Foo was another successful product for the Bobo Company. Some time later, however, a lorry crashed into the back of a Bobo Foo containing three young women. Upon impact, the fuel tank was ruptured causing a fire in which all three passengers in the car were killed. The company then began to receive other claims from lawyers acting for people killed or injured by fires started by several rear-end collisions and fuel tank damage. Bobo accepted legal advice to pay compensation for each injury or loss of life caused by the fuel tank design fault.

The board then met to discuss the options for the Bobo Foo. Kathy Yao said her team had worked out that the cars could be made safe by adding some reinforcing metalwork around the tank area. Vernon Vim, the finance director, said that there were two options in the light of what Kathy had said. First was the 'universal recall' option. The company could recall, at its own expense, all Bobo Foos to make the modifications suggested by Kathy Yao and retool the production line to ensure safe positioning of the fuel tank on all future cars. The second option, the 'compensation option', was not to recall the existing cars nor to make changes to the production line but to continue to pay full compensation to victims or their families if, or when, a serious or fatal liability arose as a result of fuel tank damage from rear collisions.

Vernon Vim produced some calculations to illustrate the dilemma. They showed that, assuming that the Bobo Foo will be produced for ten years, the universal recall option would amount to $750 million over those ten years whilst the compensation option was likely to amount to approximately $200 million in total.

Vernon Vim said that even allowing for substantial errors in the calculation, there was still at least a three-fold difference in cost between the two options. Because the board's bonuses were partly based on the company's annual profits, he said that the board should simply continue to pay compensation claims and not issue the universal recall. He reminded the board that the difference between the two options was half a billion dollars over ten years.

Kathy Yao said that the company should consider the universal recall option and think about retooling the production line to ensure the safe repositioning of the fuel tank on future production. It was important, she believed, for customers to know they could trust Bobo cars for their safety and that customers associated the brand with social responsibility. She said this was an important part of the company's strategic positioning and that the company should comply with the expectations that society has of a large company like Bobo.

Chief executive James Tsakos was concerned about complying with the expectations of shareholders and with how events might affect the company's share price and longer term prospects. The company's reputation as a strong investment was very important and any long-term damage to the brand would be very unfortunate. He said that issuing a universal recall would send out a terrible signal to the financial markets and would damage confidence.

After a lengthy and heated discussion of the two options, it was decided that the 'compensation option' would be adopted. This was for financial reasons and it was decided that any discussion of the decision in public should be avoided because of the potential risk to reputation that may arise.

An unknown member of the board, outraged by the decision, informed the media about the choice the board had made and about the design process that led to the Bobo Foo (thereby acting as a 'whistleblower'). With a great deal of resulting negative publicity for Bobo on TV, radio and in the press, the institutional shareholders demanded an extraordinary general meeting to discuss the relevant issues with the board. In particular, the shareholders wanted to hear the chief executive explain why the board took the decision it did. In particular, they wanted to hold James Tsakos accountable for the decision: to establish how he understood his role as chief executive and how he arrived at the decision not to issue a universal recall on the Bobo Foo.

(a) The fuel tank risk with the Bobo Foo was subsequently classified by an insurance company as a product and a safety risk.

Required:

Explore the circumstances leading to the fuel tank problem. Identify and explain internal control measures capable of mitigating the risk in future car development projects.

Note: Ignore any possible legal or regulatory issues that may arise. (12 marks)

(b) Explain Kohlberg's three levels of moral development and identify, with reasons, the levels of development exhibited by James Tsakos, Kathy Yao and Vernon Vim. (12 marks)

(c) Distinguish between annual general meetings (AGMs) and extraordinary general meetings (EGMs). Explain the purpose of each and the advantages of holding an EGM to discuss the issues raised by the whistleblower. (8 marks)

(d) Prepare a statement for Mr Tsakos, the chief executive, to read at the EGM to address the following areas.

(i) An explanation of the roles of the chief executive in managing the issues described in the case at Bobo Company; (8 marks)

(ii) A defence of the company's decisions on the Bobo Foo from a 'pristine capitalist' ethical perspective (using Gray, Owen & Adams's framework). (6 marks)

Professional marks will additionally be awarded in part (d) for drafting a statement that is clear, has a logical flow, is persuasive and is appropriately structured. (4 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 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)

(c) **Explain what 'related risks' are and describe how Risks E and F might be positively correlated.** (5 marks)

(d) The risk consultants reported that YGT needed to cultivate a culture of risk awareness and that this should permeate all levels of the company.

Required:

Explain and assess this advice. (6 marks)

(25 marks)

3 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:

(a) **Discuss the ways in which charities differ from public listed companies and explain how these differences affect their respective governance structures.** (9 marks)

(b) **Define 'transparency' and construct the case for greater transparency in the governance of the Horace Hoi Organisation.** (8 marks)

(c) Audit committees can have a role in reviewing internal controls and addressing areas of deficiency.

Required:

Explain how an audit committee might assist in addressing the apparent internal control deficiencies at HHO. (8 marks)

(25 marks)

4 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)

(c) The IFAC code also highlights the need for:

'up-to-date education [for directors] on ethical issues and the legal restrictions and other regulations around potential insider trading.'

Required:

Explain what 'insider dealing/trading' is and why it is an unethical and often illegal practice. (6 marks)

(25 marks)

End of Question Paper