Professional Pilot Paper – Essentials module

Professional Accountant

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 question is compulsory and MUST be attempted

1 Chemco is a well-established listed European chemical company involved in research into, and the production of, a range of chemicals used in industries such as agrochemicals, oil and gas, paint, plastics and building materials. A strategic priority recognised by the Chemco board some time ago was to increase its international presence as a means of gaining international market share and servicing its increasingly geographically dispersed customer base. The Chemco board, which operated as a unitary structure, identified JPX as a possible acquisition target because of its good product 'fit' with Chemco and the fact that its geographical coverage would significantly strengthen Chemco's internationalisation strategy. Based outside Europe in a region of growth in the chemical industry, JPX was seen by analysts as a good opportunity for Chemco, especially as JPX's recent flotation had provided potential access to a controlling shareholding through the regional stock market where JPX operated.

When the board of Chemco met to discuss the proposed acquisition of JPX, a number of issues were tabled for discussion. Bill White, Chemco's chief executive, had overseen the research process that had identified JPX as a potential acquisition target. He was driving the process and wanted the Chemco board of directors to approve the next move, which was to begin the valuation process with a view to making an offer to JPX's shareholders. Bill said that the strategic benefits of this acquisition was in increasing overseas market share and gaining economies of scale.

While Chemco was a public company, JPX had been family owned and operated for most of its thirty-five year history. Seventy-five percent of the share capital was floated on its own country's stock exchange two years ago, but Leena Sharif, Chemco's company secretary suggested that the corporate governance requirements in JPX's country were not as rigorous as in many parts of the world. She also suggested that the family business culture was still present in JPX and pointed out that it operated a two-tier board with members of the family on the upper tier. At the last annual general meeting, observers noticed that the JPX board, mainly consisting of family members, had 'dominated discussions' and had discouraged the expression of views from the company's external shareholders. JPX had no non-executive directors and none of the board committee structure that many listed companies like Chemco had in place. Bill reported that although JPX's department heads were all directors, they were not invited to attend board meetings when strategy and management monitoring issues were being discussed. They were, he said, treated more like middle management by the upper tier of the JPX board and that important views may not be being heard when devising strategy. Leena suggested that these features made the JPX board's upper tier less externally accountable and less likely to take advice when making decisions. She said that board accountability was fundamental to public trust and that JPX's board might do well to recognise this, especially if the acquisition were to go ahead.

Chemco's finance director, Susan Brown advised caution over the whole acquisition proposal. She saw the proposal as being very risky. In addition to the uncertainties over exposure to foreign markets, she believed that Chemco would also have difficulties with integrating JPX into the Chemco culture and structure. While Chemco was fully compliant with corporate governance best practice, the country in which JPX was based had few corporate governance requirements. Manprit Randhawa, Chemco's operations director, asked Bill if he knew anything about JPX's risk exposure. Manprit suggested that the acquisition of JPX might expose Chemco to a number of risks that could not only affect the success of the proposed acquisition but also, potentially, Chemco itself. Bill replied that he would look at the risks in more detail if the Chemco board agreed to take the proposal forward to its next stage.

Finance director Susan Brown, had obtained the most recent annual report for JPX and highlighted what she considered to be an interesting, but unexplained, comment about 'negative local environmental impact' in its accounts. She asked chief executive Bill White if he could find out what the comment meant and whether JPX had any plans to make provision for any environmental impact. Bill White was able to report, based on his previous dealings with JPX, that it did not produce any voluntary environmental reporting. The Chemco board broadly supported the idea of environmental reporting although company secretary Leena Sharif recently told Bill White that she was unaware of the meaning of the terms 'environmental footprint' and 'environmental reporting' and so couldn't say whether she was supportive or not. It was agreed, however, that relevant information on JPX's environmental performance and risk would be necessary if the acquisition went ahead.

Required:

(a) Evaluate JPX's current corporate governance arrangements and explain why they are likely to be considered inadequate by the Chemco board. (10 marks)

(b) Manprit suggested that the acquisition of JPX might expose Chemco to a number of risks. Illustrating from the case as required, identify the risks that Chemco might incur in acquiring JPX and explain how risk can be assessed. (15 marks)

(c) Construct the case for JPX adopting a unitary board structure after the proposed acquisition. Your answer should include an explanation of the advantages of unitary boards and a convincing case FOR the JPX board changing to a unitary structure. (10 marks)
(Including 2 professional marks)

(d) Explain FOUR roles of non-executive directors (NEDs) and assess the specific contributions that NEDs could make to improve the governance of the JPX board. (7 marks)

(e) Write a memo to Leena Sharif defining 'environmental footprint' and briefly explaining the importance of environmental reporting for JPX. (8 marks)
(Including 2 professional marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 In a recent case, it emerged that Frank Finn, a sales director at ABC Co, had been awarded a substantial over-inflation annual basic pay award with no apparent link to performance. When a major institutional shareholder, Swanland Investments, looked into the issue, it emerged that Mr Finn had a cross directorship with Joe Ng, an executive director of DEF Co. Mr Ng was a non-executive director of ABC and chairman of its remunerations committee. Swanland Investments argued at the annual general meeting that there was 'a problem with the independence' of Mr Ng and further, that Mr Finn's remuneration package as a sales director was considered to be poorly aligned to Swanland's interests because it was too much weighted by basic pay and contained inadequate levels of incentive.

Swanland Investments proposed that the composition of Mr Finn's remuneration package be reconsidered by the remunerations committee and that Mr Ng should not be present during the discussion. Another of the larger institutional shareholders, Hanoi House, objected to this, proposing instead that Mr Ng and Mr Finn both resign from their respective non-executive directorships as there was 'clear evidence of malpractice'. Swanland considered this too radical a step, as Mr Ng's input was, in its opinion, valuable on ABC's board.

Required:

(a) **Explain FOUR roles of a remunerations committee and how the cross directorship undermines these roles at ABC Co.** (12 marks)

(b) **Swanland Investments believed Mr Finn's remunerations package to be 'poorly aligned' to its interests. With reference to the different components of a director's remunerations package, explain how Mr Finn's remuneration might be more aligned to shareholders' interests at ABC Co.** (8 marks)

(c) **Evaluate the proposal from Hanoi House that both Mr Ng and Mr Finn be required to resign from their respective non-executive positions.** (5 marks)

(25 marks)

3 At a recent conference on corporate social responsibility, one speaker (Professor Cheung) argued that professional codes of ethics for accountants were not as useful as some have claimed because:

'they assume professional accountants to be rules-driven, when in fact most professionals are more driven by principles that guide and underpin all aspects of professional behaviour, including professional ethics.'

When quizzed from the audience about his views on the usefulness of professional codes of ethics, Professor Cheung suggested that the costs of writing, implementing, disseminating and monitoring ethical codes outweighed their usefulness. He said that as long as professional accountants personally observe the highest values of probity and integrity then there is no need for detailed codes of ethics.

Required:

(a) **Critically evaluate Professor Cheung's views on codes of professional ethics. Use examples of ethical codes, where appropriate, to illustrate your answer.** (12 marks)

(b) **With reference to Professor Cheung's comments, explain what is meant by 'integrity' and assess its importance as an underlying principle in corporate governance.** (7 marks)

(c) **Explain and contrast a deontological with a consequentialist based approach to business ethics.** (6 marks)

(25 marks)

4 As part of a review of its internal control systems, the board of FF Co, a large textiles company, has sought your advice as a senior accountant in the company.

FF's stated objective has always been to adopt the highest standards of internal control because it believes that by doing so it will not only provide shareholders with confidence in its governance but also enhance its overall reputation with all stakeholders. In recent years, however, FF's reputation for internal control has been damaged somewhat by a qualified audit statement last year (over issues of compliance with financial reporting standards) and an unfortunate internal incident the year prior to that. This incident concerned an employee, Miss Osula, expressing concern about the compliance of one of the company's products with an international standard on fire safety. She raised the issue with her immediate manager but he said, according to Miss Osula, that it wasn't his job to report her concerns to senior management. When she failed to obtain a response herself from senior management, she decided to report the lack of compliance to the press. This significantly embarrassed the company and led to a substantial deterioration in FF's reputation.

The specifics of the above case concerned a fabric produced by FF Co, which, in order to comply with an international fire safety standard, was required to resist fire for ten minutes when in contact with a direct flame. According to Miss Osula, who was a member of the quality control staff, FF was allowing material rated at only five minutes fire resistance to be sold labelled as ten minute rated. In her statement to the press, Miss Osula said that there was a culture of carelessness in FF and that this was only one example of the way the company approached issues such as international fire safety standards.

Required:

(a) Describe how the internal control systems at FF Co differ from a 'sound' system of internal control, such as that set out in the Turnbull guidance, for example. (10 marks)

(b) Define 'reputation risk' and evaluate the potential effects of FF's poor reputation on its financial situation. (8 marks)

(c) Explain, with reference to FF as appropriate, the ethical responsibilities of a professional accountant both as an employee and as a professional. (7 marks)

(25 marks)

End of Question Paper

Answers

1 (a) JPX's current corporate governance arrangements

Inadequacy of JPX's current corporate governance arrangements

The case highlights a number of ways in which the corporate governance at JPX is inadequate. JPX's history as a privately run family business may partly explain its apparent slowness to develop the corporate governance structures and systems expected in many parts of the world. There are five ways, from the case, that JPX can be said to be inadequate in its corporate governance although these are linked. There is overlap between the points made.

In the first instance, the case mentions that there were no independent non-executive directors (NEDs) on the JPX board. It follows that JPX would be without the necessary balance and external expertise that NEDs can provide. Second, there is evidence of a corporate culture at JPX dominated by the members of the family. The case study notes that they dominate the upper tier of the board. This may have been acceptable when JPX was a family owned company, but as a public company floated on a stock exchange and hence accountable to external shareholders, a wider participation in board membership is necessary. Third, the two-tier board, whilst not necessarily being a problem in itself (two-tier boards work well in many circumstances), raises concern because the department heads, who are on the lower tier of the board, are excluded from strategic discussions at board level. It is likely that as line managers in the business, the departmental heads would have vital inputs to make into such discussions, especially on such issues as the implementation of strategies. It is also likely that their opinions on the viabilities of different strategic options would be of value. Fourth, it could be argued that JPX's reporting is less than ideal with, for example, its oblique reference to a 'negative local environmental impact'. However, it might be noted that ambiguity in reporting is also evident in European and American reporting. Finally, having been subject to its own country's less rigorous corporate governance requirements for all of its previous history, it is likely that adjusting to the requirements of complying with the European-centred demands of Chemco will present a challenge.

(b) Risks of the proposed acquisition

Risks that Chemco might incur in acquiring JPX.

The case describes a number of risks that Chemco could become exposed to if the acquisition was successful. Explicitly, the case highlights a possible environmental risk (the 'negative local environmental impact') that may or may not be eventually valued as a provision (depending on whether or not it is likely to result in a liability). Other risks are likely to emerge as the proposed acquisition develops. Exchange rate risks apply to any business dealing with revenue or capital flows between two or more currency zones. The case explicitly describes Chemco and JPX existing in different regions of the world. Whilst exchange rate volatility can undermine confidence in cash flow projections, it should also be borne in mind that medium term increases or decreases in exchange values can materially affect the returns on an investment (in this case, Chemco's investment in JPX). There is some market risk in Chemco's valuation of JPX stock. This could be a substantial risk because of JPX's relatively recent flotation where the market price of JPX may not have yet found its intrinsic level. In addition, it is not certain that Chemco has full knowledge of the fair price to pay for each JPX share given the issues of dealing across national borders and in valuing stock in JPX's country. All mergers and acquisitions ('integrations') are exposed to synergy risks. Whilst it is expected and hoped that every merger or acquisition will result in synergies (perhaps from scale economies as the case mentions), in practice, many integrations fail to realise any. In extreme cases, the costs arising from integration can threaten the very survival of the companies involved. Finally, there are risks associated with the bringing-together of the two board structures. Specifically, structural and cultural changes will be required at JPX to bring it in line with Chemco's. The creation of a unitary board and the increased involvement of NEDs and departmental heads may be problematic, for example, Chemco's board is likely to insist on such changes post-acquisition.

Assessment of risk

The assessment of the risk exposure of any organisation has five components. Firstly, the identity (nature and extent) of the risks facing the company should be identified (such as considering the risks involved in acquiring JPX). This may involve consulting with relevant senior managers, consultants and other stakeholders. Second, the company should decide on the categories of risk that are regarded as acceptable for the company to bear. Of course any decision to discontinue exposure to a given risk will have implications for the activities of the company and this cost will need to be considered against the benefit of the reduced risk. Third, the assessment of risk should quantify, as far as possible, the likelihood (probability) of the identified risks materialising. Risks with a high probability of occurring will attract higher levels of management attention than those with lower probabilities. Fourth, an assessment of risk will entail an examination of the company's ability to reduce the impact on the business of risks that do materialise. Consultation with affected parties (e.g. departmental heads, stakeholders, etc.) is likely to be beneficial, as information on minimising negative impact may sometimes be a matter of technical detail. Fifth and finally, risk assessment involves an understanding of the costs of operating particular controls to review and manage the related risks. These costs will include information gathering costs, management overhead, external consultancy where appropriate, etc.

(c) Unitary and two-tier board structures

Advantages of unitary board structure in general

There are arguments for and against unitary and two-tier boards. Both have their 'place' depending on business cultures, size of business and a range of other factors. In general, however, the following arguments can be put for unitary boards.

One of the main features of a unitary board is that all directors, including managing directors, departmental (or divisional) directors and NEDs all have equal legal and executive status in law. This does not mean that all are equal in terms of the organisational hierarchy, but that all are responsible and can be held accountable for board decisions. This has a number of benefits. Firstly, NEDs are empowered, being accorded equal status to executive directors. NEDs can bring not only independent scrutiny to the board, but also experience and expertise that may be of invaluable help in devising strategy and the assessment of risk. Second, board accountability is enhanced by providing a greater protection against fraud and malpractice and by holding all directors equally accountable under a 'cabinet government' arrangement. These first two benefits provide a major underpinning to the confidence that markets have in listed companies. Third, unitary board arrangements reduce the likelihood of abuse of (self-serving) power by a small number of senior directors. Small 'exclusivist' boards such as have been evident in some corporate 'scandals' are discouraged by unitary board arrangements. Fourth, the fact that the board is likely to be larger than a given tier of a two-tier board means that more viewpoints are likely to be expressed in board deliberations and discussions. In addition to enriching the intellectual strength of the board, the inclusivity of the board should mean that strategies are more robustly scrutinised before being implemented.

Relevance to JPX in particular
If the JPX acquisition was to proceed, there would be a unitary board at Chemco overseeing a two-tier board at JPX. The first specific argument for JPX adopting a unitary board would be to bring it into line with Chemco's. Chemco clearly believes in unitary board arrangements and would presumably prefer to have the benefits of unitary boards in place so as to have as much confidence as possible in JPX's governance. This may be especially important if JPX is to remain an 'arms length' or decentralised part of Chemco's international operation. Second, there is an argument for making changes at JPX in order to signal a departure from the 'old' systems when JPX was independent of the 'new' systems under Chemco's ownership. A strong way of helping to 'unfreeze' previous ways of working is to make important symbolic changes and a rearrangement of the board structure would be a good example of this. Third, it is clear that the family members who currently run JPX have a disproportionate influence on the company and its strategy (the 'family business culture'). Widening the board would, over time, change the culture of the board and reduce that influence. Fourth, a unitary board structure would empower the departmental heads at JPX whose opinions and support are likely to be important in the transition period following the acquisition.

(d) **Non executive directors**

Four roles of non-executive directors.
The Higgs Report (2003) in the United Kingdom helpfully described the function of non-executive directors (NEDs) in terms of four distinct roles. These were the strategy role, the scrutinising role, the risk advising role and the 'people' role. These roles may be undertaken as part of the general discussion occurring at Board meetings or more formally, through the corporate governance committee structure.

The strategy role recognises that NEDs are full members of a unitary board and thus have the right and responsibility to contribute to the strategic success of the organisation for the benefit of shareholders. In this role they may challenge any aspect of strategy they see fit, and offer advice or input to help to develop successful strategy.

In the scrutinising role, NEDs are required to hold executive colleagues to account for decisions taken and results obtained. In this respect they are required to represent the shareholders' interests against the possibility that agency issues arise to reduce shareholder value.

The risk role involves NEDs ensuring the company has an adequate system of internal controls and systems of risk management in place. This is often informed by prescribed codes (such as Turnbull) but some industries, such as chemicals, have other systems in place, some of which fall under International Organisation for Standardisation (ISO) standards.

Finally, the 'people' role involves NEDs overseeing a range of responsibilities with regard to the management of the executive members of the board. This typically involves issues on appointments and remuneration, but might also involve contractual or disciplinary issues.

Specific benefits for JPX of having NEDs
The specific benefits that NEDs could bring to JPX concern the need for a balance against excessive family influence and the prior domination of the 'family business culture'. Chemco, as JPX's new majority shareholder, is unlikely to want to retain a 'cabal' of an upper tier at JPX and the recruitment of a number of NEDs will clearly help in that regard. Second, NEDs will perform an important role in representing external shareholders' interests (as well as internal shareholders). Specifically, shareholders will include Chemco. Third, Chemco's own board discussion included Bill White's view that the exclusion of departmental heads was resulting in important views not being heard when devising strategy. This is a major potential danger to JPX and NEDs could be appointed to the board in order to ensure that future board discussions include all affected parties including the previously disenfranchised department heads.

(e) Environmental reporting.

Memorandum

From: Professional Accountant
To: Leena Sharif

Date: DD/MM/YYYY

Re: environmental issues at Chemco and JPX

1. Introduction

I have been asked to write to you on two matters of potential importance to Chemco in respect of environmental issues. The first of these is to consider the meaning of the term, 'environmental footprint' and the second is to briefly review the arguments for inviting JPX (should the acquisition proceed) to introduce environmental reporting.

2. 'Environmental footprint'

Explanation of 'environmental footprint'
The use of the term 'footprint' with regard to the environment is intended to convey a meaning similar to its use in everyday language. In the same way that humans and animals leave physical footprints that show where they have been, so organisations such as Chemco leave evidence of their operations in the environment. They operate at a net cost to the environment. The environmental footprint is an attempt to evaluate the size of Chemco's impact on the environment in three respects. Firstly, concerning the company's resource consumption where resources are defined in terms of inputs such as energy, feedstock, water, land use, etc. Second, concerning any harm to the environment brought about by pollution emissions. These include emissions of carbon and other chemicals, local emissions, spillages, etc. It is likely that as a chemical manufacturer, both of these impacts will be larger for Chemco than for some other types of business. Thirdly, the environmental footprint includes a measurement of the resource consumption and pollution emissions in terms of harm to the environment in either qualitative, quantitative or replacement terms.

3. Environmental reporting at JPX.

Arguments for environmental reporting at JPX
There are number of arguments for environmental reporting in general and others that may be specifically relevant to JPX. In general terms and firstly, I'm sure as company secretary you will recognise the importance of observing the corporate governance and reporting principles of transparency, openness, responsibility and fairness wherever possible. We should invite JPX to adopt these values should the acquisition proceed. Any deliberate concealment would clearly be counter to these principles and so 'more' rather than 'less' reporting is always beneficial. Second, it is important to present a balanced and understandable assessment of the company's position and prospects to external stakeholders. Third, it is important that JPX recognises the existence and size of its environment footprint, and reporting is a useful means if doing this. Fourth, and specifically with regard to JPX and other companies with a substantial potential environmental footprint, there is a need to explain environmental strategy to investors and other interested stakeholders (eg Chemco). Finally, there is a need to explain in more detail the 'negative local environmental impact' and an environmental report would be an ideal place for such an explanation.

Summary:

As JPX's 'environmental footprint' is potentially quite large, it is important that Chemco ensures as far as possible, that any such footprint left by JPX is known and measured. Additionally, in the interests of transparency, openness, responsibility and fairness, it is important that it is also fully reported upon for the information of both investors and other interested stakeholders.

2 (a) Remunerations committees and cross directorships

Remunerations committees
Remunerations committees comprise an important part of the standard board committee structure of good corporate governance.

The major roles of a remuneration committee are as follows. Firstly, the committee is charged with determining remunerations policy on behalf of the board and the shareholders. In this regard, they are acting on behalf of shareholders but for the benefit of both shareholders and the other members of the board. Policies will typically concern the pay scales applied to directors' packages, the proportions of different types of reward within the overall package and the periods in which performance related elements become payable.

Secondly the committee ensures that each director is fairly but responsibly rewarded for their individual contribution in terms of levels or pay and the components of each director's package. It is likely that discussions of this type will take place for each individual director and will take into account issues including market conditions, retention needs, long-term strategy and market rates for a given job.

Third, the remunerations committee reports to the shareholders on the outcomes of their decisions, usually in the corporate governance section of the annual report (usually called Report of the Remunerations Committee). This report, which is auditor reviewed, contains a breakdown of each director's remuneration and a commentary on policies applied to executive and non-executive remuneration.

Finally, where appropriate and required by statute or voluntary code, the committee is required to be seen to be compliant with relevant laws or codes of best practice. This will mean that the remunerations committee will usually be made up of non-executive members of the board and will meet at regular intervals.

Cross directorships
Cross directorships represent a threat to the efficient working of remunerations committees. A cross directorship is said to exist when two (or more) directors sit on the boards of the other. In practice, such arrangements also involve some element of cross-shareholdings which further compromises the independence of the directors involved. In most cases, each director's 'second' board appointment is likely to be non-executive. Cross directorships undermine the roles of remunerations committees in that a director deciding the salary of a colleague who, in turn, may play a part in deciding his own salary, is a clear conflict of interests. Neither director involved in the arrangement is impartial and so a temptation would exist to act in a manner other than for the benefit of the shareholders of the company on whose remunerations committee they sit. It is for this reason the cross directorships and cross shareholding arrangements are explicitly forbidden by many corporate governance codes of best practice.

(b) Mr Finn's remunerations package

Different components of directors' rewards
The components of a director's total rewards package may include any or all of the following in combination. The basic salary is not linked to performance in the short run but year-to-year changes in it may be linked to some performance measures. It is intended to recognise the basic market value of a director. A number of benefits in kind may be used which will vary by position and type of organisation, but typically include company cars, health insurance, use of health or leisure facilities, subsidised or free use of company products (if appropriate), etc. Pension contributions are paid by most responsible employers, but separate directors' schemes may be made available at higher contribution rates than other employees. Finally, various types of incentives and performance related components may be used. Short to medium term incentives such as performance-related annual bonuses will encourage a relatively short term approach to meeting agreed targets whilst long term incentives including share options can be used for longer term performance measures.

Mr Finn's remuneration package
The case mentions that, "Mr Finn's remuneration package as a sales director was considered to be poorly aligned to Swanland's interests because it was too much weighted by basic pay and contained inadequate levels of incentive."

The alignment of director and shareholder interests occurs through a careful design of the performance related components of a director's overall rewards. The strategic emphases of the business can be built into these targets and Mr Finn's position as a sales director makes this possible through incentives based on revenue or profit targets. If current priorities are for the maximisation of relatively short-run returns, annual, semi-annual or even monthly performance-related bonuses could be used. More likely at board level, however, will be a need for longer-term alignments for medium to long-term value maximisation. While Mr Finn may be given annual or even quarterly or monthly bonus payments against budget, longer-term performance can be underpinned through share options with a relevant maturity date or end-of-service payouts with agreed targets. The balance of short and longer-term performance bonuses should be carefully designed for each director with metrics within the control of the director in question.

(c) Evaluation of the proposal from Hanoi House.

The dilemma over what action to take in the light of Mr Ng and Mr Finn's cross directorship is a typical problem when deciding how to address issues of conflicts of interest. Should the situation be 'put right' at minimum cost, or should the parties in the arrangement be punished in some way as Hanoi House suggested? Swanland's more equivocal suggestion (that the remunerations committee reconsider Mr Finn's remuneration package without Mr Ng being present) may be more acceptable to some shareholders. This debate touches on the ethical issues of a pragmatic approach to some issues compared to a dogmatic approach.

For the proposal
Hanoi House's more radical proposal would have a number of potential advantages. Specifically, it could be argued that the resignation of both men from their respective NED positions would restore ABC shareholders' confidence in the remunerations committee. The appearance of probity is sometimes as important as the substance and resignations can sometimes serve to purge a problem to everybody's (except for the director in question's) benefit. The double resignation would signal a clean break in the apparently compromising relationship between Mr Finn and Mr Ng and, certainly as far as ABC was concerned, would resolve the problem decisively. It would signal the importance that ABC placed on compliance with corporate governance best practice and this, in turn, would be of comfort to shareholders and analysts concerned with the threat to the independence of ABC's remunerations committee.

Against the proposal
Hanoi House's proposal was seen as too radical for Swanland. Among its concerns was the belief that only Mr Ng's resignation from ABC's remunerations committee would be strictly necessary to diffuse the situation. Clearly Swanland saw no problem with Mr Finn's position on the ABC board in his executive capacity. Furthermore, it took a pragmatic view of Mr Ng's position as NED on ABC's board. It considered Mr Ng's input to be valuable on the ABC board and pointed out that this input would be lost if Hanoi House's proposal was put into practice. Hanoi House may therefore have been mindful of the assumed deficit of talent at senior strategic level in corporate management and accordingly, wished to retain both Mr Finn's and Mr Ng's expertise if at all possible.

3 (a) Professor Cheung's views on codes of professional ethics

Professor Cheung adopts a sceptical stance with regard to codes of ethics. There are arguments both supporting and challenging his views.

Supporting Professor Cheung's opinion
Professional codes of ethics have a number of limitations, some of which Professor Cheung referred to. Because they contain descriptions of situations that accountants might encounter, they can convey the (false) impression that professional ethics can be reduced to a set of rules contained in a code (as pointed out by Professor Cheung). This would be a mistaken impression, of course, as the need for personal integrity is also emphasised. Ethical codes do not and cannot capture all ethical circumstances and dilemmas that a professional accountant will encounter in his or her career and this reinforces the need for accountants to understand the underlying ethical principles of probity, integrity, openness, transparency and fairness. Although codes such as IFAC's are intended to apply to an international 'audience', some may argue that regional variations in cultural, social and ethical norms mean that such codes cannot capture important differences in emphasis in some parts of the world. The moral 'right' can be prescribed in every situation. Finally, professional codes of ethics are not technically enforceable in any legal manner although sanctions exist for gross breach of the code in some jurisdictions. Individual observance of ethical codes is effectively voluntary in most circumstances.

Against Professor Cheung's opinion
There are a number of arguments for codes of professional ethics that challenge Professor Cheung's views. Firstly, professional codes of ethics signal the importance, to accountants, of ethics and acting in the public interest in the professional accounting environment. They are reminded, unambiguously and in 'black and white' for example, that as with other professions, accounting exists to serve the public good and public support for the profession is likely to exist only as long as the public interest is supported over and above competing interests. The major international codes (such as IFAC) underpin national and regional cultures with internationally expected standards that, the codes insist, supersede any national ethical nuances. The IFAC (2003) code states (in clause 4), "the accountancy profession throughout the world operates in an environment with different cultures and regulatory requirements. The basic intent of the Code, however, should always be respected." The codes prescribe minimum standards of behaviour expected in given situations and give specific examples of potentially problematic areas in accounting practice. In such situations, the codes make the preferred course of action unambiguous.

A number of codes of ethics exist for professional accountants. Prominent among these is the IFAC code. This places the public interest at the heart of the ethical conduct of accountants. The ACCA code discusses ethics from within a principles-based perspective. Other countries' own professional accounting bodies have issued their own codes of ethics in the belief that they may better describe the ethical situations in those countries.

(b) Integrity

Meaning of 'integrity'
Integrity is generally understood to describe a person of high moral virtue. A person of integrity is one who observes a steadfast adherence to a strict moral or ethical code notwithstanding any other pressures on him or her to act otherwise. In professional life, integrity describes the personal ethical position of the highest standards of professionalism and probity. It is an underlying and underpinning principle of corporate governance and it is required that all those representing shareholder interests in agency relationships both possess and exercise absolute integrity at all times. To fail to do so is a breach of the agency trust relationship.

Importance of integrity in corporate governance
Integrity is important in corporate governance for several reasons. Codes of ethics do not capture all ethical situations and the importance of the virtue of the actor rather than the ethics of the action is therefore emphasised. Any profession (such as accounting) relies upon a public perception of competence and integrity and in this regard, accounting can perhaps be compared with medicine. As an underlying principle, integrity provides a basic ethical framework to guide an accountant's professional and personal life. Finally, integrity underpins the relationships that an accountant has with his or her clients, auditors and other colleagues. Trust is vital in the normal conduct of these relationships and integrity underpins this.

(c) Deontology and consequentialism

Deontological ethics
The deontological perspective can be broadly understood in terms of 'means' being more important than 'ends'. It is broadly based on Kantian (categorical imperative) ethics. The rightness of an action is judged by its intrinsic virtue and thus morality is seen as absolute and not situational. An action is right if it would, by its general adoption, be of net benefit to society. Lying, for example, is deemed to be ethically wrong because lying, if adopted in all situations, would lead to the deterioration of society.

Consequentialist ethics
The consequentialist or teleological perspective is based on utilitarian or egoist ethics meaning that the rightness of an action is judged by the quality of the outcome. From the egoist perspective, the quality of the outcome refers to the individual ("what is best for me?"). Utilitarianism measures the quality of outcome in terms of the greatest happiness of the greatest number ("what is best for the majority?"). Consequentialist ethics are therefore situational and contingent, and not absolute.

4 (a) FF plc and a 'sound' system of internal control

Features of sound control systems

The Turnbull code employs the term 'sound' to indicate that it is insufficient to simply 'have' an internal control system. They can be effective and serve the aim of corporate governance or they can be ineffective and fail to support them. In order to reinforce 'soundness' or effectiveness, systems need to possess a number of features. The Turnbull guidance described three features of a 'sound' internal control system.

Firstly, the principles of internal control should be embedded within the organisation's structures, procedures and culture. Internal control should not be seen as a stand-alone set of activities and by embedding it into the fabric of the organisation's infrastructure, awareness of internal control issues becomes everybody's business and this contributes to effectiveness.

Secondly, internal control systems should be capable of responding quickly to evolving risks to the business arising from factors within the company and to changes in the business environment. The speed of reaction is an important feature of almost all control systems (for example a servo system for vehicle brakes or the thermostat on a heating system). Any change in the risk profile or environment of the organisation will necessitate a change in the system and a failure or slowness to respond may increase the vulnerability to internal or external trauma.

Thirdly, sound internal control systems include procedures for reporting immediately to appropriate levels of management any significant control failings or weaknesses that are identified, together with details of corrective action being undertaken. Information flows to relevant levels of management capable and empowered to act on the information are essential in internal control systems. Any failure, frustration, distortion or obfuscation of information flows can compromise the system. For this reason, formal and relatively rigorous information channels are often instituted in organisations seeking to maximise the effectiveness of their internal control systems.

Shortcomings at FF plc.

The case highlights a number of ways in which the internal control at FF fell short of that expected of a 'sound' internal control system. First, and most importantly, the case suggests that the culture of FF did not support good internal control. Miss Osula made reference to, "culture of carelessness in FF" and said that the issue over the fire safety standards, "was only one example of the way the company approached issues such as international fire safety standards." While having systems in place to support sound internal control, it is also important to have a culture that also places a high priority on it. Second, there is evidence of a lack of internal control and reporting procedures at FF. Not only was the incorrect fire-rating labelling not corrected by senior management, the attempt to bring the matter to the attention of management was also not well-received.

Third, there is evidence of structural/premeditated contravention of standards (and financial standards) at FF. In addition to the fire safety issue, the case makes reference to a qualified audit statement over issues of compliance with financial standards. There is ample evidence for shareholders to question the competence of management's ability to manage the internal control systems at FF.

(b) Reputation risk

Defining reputation risk

Reputation risk is one of the categories of risk used in organisations. It was identified as a risk category by Turnbull and a number of events in various parts of the world have highlighted the importance of this risk. Reputation risk concerns any kind of deterioration in the way in which the organisation is perceived, usually, but not exclusively, from the point of view of external stakeholders. The cause of such deterioration may be due to irregular behaviour, compliance failure or similar, but in any event, the effect is an aspect of corporate behaviour below that expected by one or more stakeholder. When the 'disappointed' stakeholder has contractual power over the organisation, the cost of the reputation risk may be material.

Effects of poor reputation on financial situation

There are several potential effects of reputation risk on an affected organisation. When more than one stakeholder group has reason to question the otherwise good reputation of an organisation, the effect can be a downward spiral leading to a general lack of confidence which, in turn, can have unfortunate financial effects. In particular, however, reputation risk is likely to affect one or more of the organisation's interactions with resource providers, product buyers, investors or auditors/regulators. Resource provision (linked to resource dependency theory) may affect recruitment, financing or the ability to obtain other inputs such as (in extremis) real estate, stock or intellectual capital. Within product markets, damage to reputation can reduce confidence among customers leading to reduced sales values and volumes and, in extreme cases, boycotts. Investor confidence is important in public companies where any reputation risk is likely to be reflected in market value. Finally, auditors, representing the interests of shareholders, would have reason to exercise increased scrutiny if, say, there are problems with issues of trust in a company. It would be a similar situation if the affected organisation were in an industry subject to high levels of regulation.

FF and reputation

At FF, the sources of the potential threat to its reputation arise from a failure to meet an external standard, an issue over product confidence and a qualified audit statement. The failure to meet an external standard concerned compliance with international fire safety standards. The issue over product confidence involved selling one product falsely rated higher than the reality. These would be likely to affect customer confidence and the attitude of any fire safety accrediting body. The qualified audit statement would be likely to intensify the attention to detail paid by auditors in subsequent years.

(c) **Ethical responsibilities of a professional accountant**

A professional accountant has two 'directions' of responsibility: one to his or her employer and another to the highest standards of professionalism.

Responsibilities to employer
An accountant's responsibilities to his or her employer extend to acting with diligence, probity and with the highest standards of care in all situations. In addition, however, an employer might reasonably expect the accountant to observe employee confidentiality as far as possible. In most situations, this will extend to absolute discretion of all sensitive matters both during and after the period of employment. The responsibilities also include the expectation that the accountant will act in shareholders' interests as far as possible and that he or she will show loyalty within the bounds of legal and ethical good practice.

Responsibilities as a professional
In addition to an accountant's responsibilities to his or her employer, there is a further set of expectations arising from his or her membership of the accounting profession. In the first instance, professional accountants are expected to observe the letter and spirit of the law in detail and of professional ethical codes where applicable (depending on country of residence, qualifying body, etc.). In any professional or ethical situation where codes do not clearly apply, a professional accountant should apply 'principles-based' ethical standards (such as integrity and probity) such that they would be happy to account for their behaviour if so required. Finally, and in common with members of other professions, accountants are required to act in the public interest that may, in extremis, involve reporting an errant employer to the relevant authorities. This may be the situation that an accountant may find him or herself in at FF. It would clearly be unacceptable to be involved in any form of deceit and it would be the accountant's duty to help to correct such malpractice if at all possible.

1 (a) Up to two marks per valid point made on the inadequacy of JPX's governance
(Up to a maximum of ten in total)

(b) One mark for identifying and describing each risk to Chemco in the JPX acquisition up to a maximum of six.
Up to one mark per relevant point on assessing each risk and a further one mark for development of relevant points up to a maximum of ten.
(Up a maximum of fifteen in total)

(c) Award one mark for each relevant point made.
(i) Up to four marks for an explanation of the advantages of unitary boards
(ii) Up to five marks for the case concerning the advantages of a unitary board at JPX.
(iii) Up to two marks for the clarity and persuasiveness of the argument for change in the JPX board.
(Up to a maximum of ten in total)

d) Award one mark for each explanation of the four roles of non-executive directors up to a maximum of four marks.

Award one mark for each specific benefit of NEDs to JPX up to a maximum of four marks.
(Up to a maximum of seven marks in total)

(e) Memo to Leena Sharif.
Explaining environmental footprint – one mark for each relevant point made up to a maximum of two marks.
Explaining importance of environmental reporting – one mark for each relevant point made up to a maximum of four marks.

Up to two marks for the form of the answer (memo in which content is laid out in an orderly and informative manner).
(Up to a maximum of eight in total)

(50 marks)

2 (a) (i) One mark for each valid point made up to a maximum of two for demonstrating an understanding of cross directorships.
(ii) Award up to two marks for each valid point made on roles of remunerations committees up to a maximum of eight.
(iii) Award up to two marks for each valid point on undermining the roles up to a maximum of four.
(Up to a maximum of twelve marks in total)

b) One mark for each components of a director's remuneration correctly identified up to a maximum of four.
One mark for each relevant point describing how Finn's remuneration might be more aligned to shareholders' interests up to a maximum of five.
(Up to a maximum of eight marks in total)

(c) Award one mark for each point evaluating the proposal from Hanoi House:
Arguments in favour – up to three marks,
Arguments against – up to three marks.
(Up to a maximum of five marks in total).

(25 marks)

3 (a) Award one mark for each valid point made supporting codes of professional ethics up to a maximum of six.
Award one mark for each valid point made on limitations of codes of professional ethics up to a maximum of six.
Up to two marks for using an actual code of ethics by way of example.
(Up to a maximum of eleven marks in total)

(b) Definition of integrity – one mark for each relevant point up to a maximum of four.
Importance of integrity – one mark for each relevant point up to a maximum of four.
(Up to a maximum of seven marks in total)

(c) Explanation of deontology – one mark for each valid point up to a maximum of four marks
Explanation of consequentialism – one mark for each valid point up to a maximum of four marks
(Up to a maximum of seven marks in total)

(25 marks)

4 (a) Description of 'sound' control systems – up to two marks for each valid point made up to a maximum of six.
Explanation of shortcomings at FF plc – one mark for each valid point made up to a maximum of six.
(Up to a maximum of ten marks in total)

(b) Definition of 'reputation risk' – one mark for each valid point made up to a maximum of three.
Explanation of the financial effects of poor reputation – one mark for each valid point made up to a maximum of four.
Recognition of the causes of FF's reputation problems – one mark for each valid point made up to a maximum of two.
(Up to a maximum of eight marks in total)

(c) Responsibilities to employer – one mark for each valid point made up to a maximum of four.
Responsibilities to professionalism – one mark for each valid point made up to a maximum of four.
(Up to a maximum of seven marks in total)

(25 marks)