

First section

QUESTION (1) Compulsory:

The board of worldwide minerals (WM) was meeting for the last monthly meeting before the publication of the year-end results. There were two points of discussion on the agenda. First was the discussion of the year-end results, second was the crucial latest minerals reserves report.

WM is a large listed multinational company that deals with natural that are extracted from the ground, processed and sold to a wide range of industrial and construction companies. In order to maintain a consistent supply on minerals into its principal markets, an essential part of WM's business strategy is the seeking out of new sources and the measurement of known reserves. Investment analysts have often pointed out that WM's value rests principally upon the accuracy of its reserve reports, as these are the best indicators of future cash flows and earnings. In order to support this key part of its strategy, WM has a large and well-funded geological survey department which, according to the company website, contains 'some of the world's best geologists and minerals scientists'. In its investor relations literature, the company claims that.

'Our experts search the earth for mineral reserves and once located, they are carefully measured so that the company can always report on known reserves. This knowledge underpins market confidence and keeps our customers supplies with the inventory they need. You can trust our reserve reports-our reputation depends on it!'

At the board meeting the head of the geological survey department, reported that there was a problem with the latest report because one of the major reserve figures hat recently was found to be wrong. The mineral in question, was WM's largest mineral in volume terms and explained that the reserves in a deep mine in a certain part of the world had been significantly overestimated. One explained that, based on the interim minerals report, the stock market analysts were expecting WM to announce known reserves of 4.8 billion tones. The actual figure was closer to 2.4 billion tones. It was agreed that this difference was sufficient to affect WM's market value, despite the otherwise good results for the past year. The finance director said that the share price reflects market confidence in future earnings. He said that an announcement of an incorrect estimation like that would cause a reduction in share value. More importantly for WM itself, however, it could undermine confidence in the geological survey department. All agreed that as this was strategically important for the company, it was a top priority to deal with this problem.

The head of geological survey department explained how the situation had arisen. The major mine was in a country new to WM's operations. The WM engineer at the mine said it was difficult to deal with some local people because, according to the engineer, 'they didn't like to give us bad news'. The engineer explained that when the mine was found to be smaller than originally thought, he was not told until it was too late to reduce the price paid for the mine. This was embarrassing and it was agreed that it would affect market confidence in WM if it were made public.

The board discussed the options open to it. The chairman, who was a qualified accountant, began by expressing serious concern about the overestimation and then invited the board to express views freely. The operation director, said that because disclosing the error to the market would be so damaging, it might be best to keep it a secret and hope that new reserves can be found in near future that will make up for

the shortfall. He said that it was unlikely that this concealment would be found out as shareholders trusted WM and they had many years of good investor relations to draw on. The finance director, reminded the board that the company was bound to certain standards of truthfulness and transparency by its stock market listing. He pointed out that they were constrained by codes of governance and ethics by the stock market and that colleague should be aware that WM would be in technical breach of these if the incorrect estimation was concealed from investors. Finally, the human resources director said that the error should be disclosed to the investors because he would not want to be deceived if he were an outside investor in the company. He argued that whatever the governance codes said and whatever the cost in terms of reputation and market value. WM should admit its error and cope with whatever consequences arose. The WM board contains three non-executive directors and their views were also invited.

At the preliminary results presentation some time later, one analyst, who had become aware of the problem, asked about internal audit control systems, and whether they were adequate in such a reserve-sensitive industry. WM's chairman, said that he intended to write a letter to all investors and analysts in the light of the problem which he hoped would address some of the issues.

Required:

(a) Define 'transparency' and evaluate its importance as an underlying principle in corporate governance and in relevant and reliable financial reporting. Your answer should refer to the case as appropriate.

(10 marks)

(b) Explain Kohlberg's three levels of moral development and identify the levels of moral development demonstrated by the contributions of organisation finance director operation director human resources director.

(12 marks)

(c) Critically discuss FOUR principal roles of non-executive directors and explain the potential tensions between these roles that WM's non-executive directors may experience in advising on the disclosure of the overestimation of the reserve.

(12 marks)

(d) Draft a letter for chairman to send to WM's investors to include the following :

(i) Why you believe robust internal controls to be important, and

(ii) Proposals on how internal systems might be improved in the light of the overestimation of reserve.

Note: four professional marks are available within the marks allocated to requirement (d) for structure, content, style and layout of the letter.

(16 marks)

(50 marks)

Second Section
Answer two questions only

QUESTION (2):

Salim was recently appointed as a non-executive member of the audit committee of Alhukeer, a public listed company producing complex engineering products. Osman, 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, 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 Salim asked about operational controls in the production facility Osman said that these were not the concern of the 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.

Salim, however, was concerned with the operational and quality controls in the production facility. He spoke to audit director, and asked if he would be prepared to produce regular reports for the audit committee on levels of specification compliance and other control issues. The production manager said that the 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 audit committee and saw no reason as to why he should start doing so now.

At board level, the non-executive chairman, Alhukeer said that he only instituted audit committee in the first place in order to be seen to be in compliance with the stock market's requirement that co. should have one. He believed that the 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 Alhukeer 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 Osman believed that only financial control information was important and he could get that information from his management accountant.

Salim asked the chairman if he recognised that the company was exposing itself to increased market risks by failing to have an effective audit committee. The chairman said he didn't know what a market risk was.

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

Required:

- (a) (i) **Describe FIVE general objectives of internal control.** (5 marks)
(ii) **Explain the organisational factors that determine the need for internal audit in public listed companies.** (5 marks)
- (b) **Criticise the internal control and internal audit arrangements at Alhukeer co. as described in the case scenario.** (10 marks)
- (c) **Define 'market risk' for the chairman and explain why Alhukeer's co. market risk exposure is increased by failing to have an effective audit committee.**

QUESTION (3):

It was the final day of a two-week-long audit of Gapco Company, a longstanding client of Abdelhaleem co. auditors. In the afternoon, Hanan, 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, Zakaria, as an 'irregularity'. A large and material cash payment had been recorded with no recipient named. The corresponding invoice was handwritten a scrap of paper and the signature was illegible.

Zakaria, the audit partner, was under pressure to finish the audit that afternoon. He advised Hanan to seek an explanation from Mubark, the client's finance director. Zakaria told her that Gapco was a longstanding client of Abdelhaleem 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 Gapco audit for last eight years and that it had always been without incident. He also said that Mubark was an old friend of this from university days and that he was certain that he wouldn't approve anything unethical or illegal. Zakaria said that Hanan had also done some consultancy for Gapco so it was a very important client that he didn't want Abdelhaleem co to upset with unwelcome and uncomfortable questioning.

When Hanan sought an explanation from Mubark, 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 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 Hanan told Zakaria what Mubark had said, Zakaria agreed not to get the audit signed off without Hanan's supports' but warned her that she should be very certain that the irregularity was worth delaying the signoff for. It was therefore now Hanan's decision whether to extend that audit or have it signed off by the end of Thursday afternoon.

Required:

- (a) Explain why 'auditor independence' is necessary in auditor-client relationships and describe THREE threats to auditor independence in the case.**

(9 marks)

Hanan is experiencing some tension due to the conflict between her duties and responsibilities as an employee of Abdelhaleem co and as a qualified professional accountant.

Required:

- (b) (i) Compare and contrast her duties and responsibilities in the two roles of employee and professional accountant.** (6 marks)
- (ii) Explain the ethical tensions between these roles that Hanan is now experiencing.** (4 marks)

(c) Explain how absolutist (dogmatic) and relativist (pragmatic) ethical assumptions would affect the outcome of Hanan's decision.

(6 marks)

(Total 25 marks)

QUESTION (4):

At a recent conference on corporate social responsibility, one speaker (professor Hamed) 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 professional 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 Hamed 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 Hamed'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 Hamed's comments, explain what is meant '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)

'End of question'