

First section

QUESTION (1) Compulsory:

A report was recently published by an international accounting organisation on the future of certain rare chemicals used in industrial processes. The report said that some of these chemicals, crucial to many industrial processes, were now so scarce that there was a threat to supply chains for items such as computer circuitry and the rechargeable batteries used in electronic goods. One of these scarce and rare chemicals, the highly toxic (TY2), has become increasingly rare and, therefore, very expensive. It requires careful processing and, although used in small quantities in each product, its high cost means that even small inefficiencies in its treatment can disproportionately affect final product costs.

The report's conclusions included this statement: 'Put simply, we are living beyond the planet's means. Businesses that use these materials will experience new risks. It may even become seen as socially unacceptable to use some of these materials. Finally, if supply stops, then manufacturing stops.'

One company which depends on a continuous and reliable supply of TY2 is Hab co Company. Hab co is a listed company based in the highly developed country. It has, for several years, designed and developed its products but and then outsourced manufacturing to another company, Tesland co, which is based in the developing country of Teeland. This means that Tesland co manufactures Hab co's products for an agreed price and to Hab co's designs and technical specifications.

Because Tesland co is based (a developing country with lower land and labour costs), working with Tesland co has offered Hab co cost advantages over manufacturing its products in its home country. As a company which outsources many of its functions, Hab co tries to ensure that in each case of outsourcing, working conditions and environmental responsibility are the same at each outsourcing company as they would be if carried out in its highly-regulated home country.

Hab co itself is one of the most valuable companies on its country stock exchange and has strategically positioned itself as a company that is seen as a trustworthy and responsible producer, that is also responsible in its social and environmental behaviour. In its press statements and annual reports, it has frequently highlighted the high value it places on integrity and transparency as fundamental values in its corporate governance. It has recently considered producing an annual environmental report, as it believes its shareholders would value the information it contains.

Tesland co is an experienced producer of electronic circuits and has a long history of working with TY2. It has relationships with the main TY2 suppliers going back many years, and these relationships ensure that it can normally obtain supplies even during periods when world supply is short. Because the supply quality of TY2 varies widely,

Tesland co has developed finely-tuned methods of ensuring that the TY2 received is of suitable quality. The performance of the finished product is very sensitive to the quality of the TY2 and so this pre-production testing is considered vital. In addition, TY2's toxicity and high cost mean that other systems are put in place at Tesland co to ensure that it is safely stored until needed for manufacture.

Earlier this year, however, two issues arose at Tesland co which caused Hab co to reconsider its outsourcing relationship.

The first one was the publication of an international media report showing evidence that, despite Hab co's claims about having the same working conditions at all of its outsourcing clients, labour conditions were unacceptably poor at Tesland co. Because labour regulations were less stringent in its country, Tesland co had been forcing employees to work excessively long hours without breaks, and other measures that would not have been permitted in Hab co country. It was reported that workers were being bullied, and threatened with dismissal if they complained about their working conditions.

The second problem was a leakage of unprocessed TY2 from the Tesland co factory. Not only was this seen as wasteful and careless, it also poisoned a local river, killing many fish and contaminating local farmland. The community living nearby said that it would be unable to use the contaminated land for many years and that this would affect local food supply.

When a journalist, Mariem, discovered information about these two issues, the media interpreted the story as a problem for Hab co, partly because of its reputation as a responsible company. Hab co's own research had shown that many of its customers valued its environmental reputation and that some of its key employees were attracted to Hab co for the same reason.

Some important customers began to associate Hab co directly with the problems at Tesland co, even though it was Tesland co which had actually been responsible for the employee issues and also the TY2 leak. Hab co's share price fell when some investors considered the problems to be important enough to undermine future confidence in Hab co's management and brand value.

In an effort to protect its reputation in future, Hab co began to review its outsource arrangement with Tesland co. The board considered the options for taking manufacturing under its own direct control by building a new factory in another low-cost country, which would be owned and operated by Hab co. It quickly realised that stopping the outsourcing relationship with Tesland co would mean the loss of about 1,000 jobs there and could also raise the likelihood of legal action by Tesland co against Hab co for loss of contract. As Hab co's manufacturing contract is so valuable to Tesland co, some people thought it likely that Tesland co would sue Hab co for loss of future earnings, despite the terms of the contract being legally ambiguous. This lack of clarity in the contract arose because of differences in laws between their two countries and as a consequence of poor legal advice that Hab co received when drawing up the contract. It was believed that any legal action would be widely reported because of Hab co's international profile and that this may result in some unfavourable publicity.

When considering its options for a directly-owned factory, Hab co's plan was to build a modern and efficient plant with 'state of the art' environmental controls. Lowland was chosen as a suitable country and Hab co narrowed the choice down to two possible sites in Lowland for its new factory: Baly and Faly. The mayors of both towns wrote to Hab co's chief executive saying that they would welcome any potential investment from Hab co. In addition, the mayor of Baly asked for a 'personal gift' (relatively immaterial although not a trivial amount to Hab co but a large amount of money locally) to facilitate a trouble-free passage of the necessary planning permission for a new Hab co factory in the town.

When deciding between Baly and Faly in Lowland, the general view was that, all other things being equal,

Baly was a better location. But there was some discussion about whether the 'personal gift' requested by the mayor of Baly was ethical. The board thought that the decision was an important one and so took some time to reflect before reaching a decision on whether to continue with Tesland co or to build a new factory in either Baly or Faly.

Having become aware that investing in Baly and paying the money to its mayor was being considered by Hab co, a member of the chief executive's office staff informed the journalist, Mariem, and a story appeared in an Essland national newspaper saying, 'Hab co considers paying a bribe to get preferred site in Lowland.' Mariem made remarks challenging Hab co's claims about integrity and transparency, and suggested that recent events had shown that it had demonstrated neither. Public discussion then took place on the internet saying that Hab co, previously considered a highly ethical company, had been corrupt and incompetent, both in allowing Tesland co to breach employment and environmental best practice, and then to consider paying a bribe to the mayor of Baly. It was decided that, in seeking to restore its reputation, the company needed to publish a detailed press statement responding to the issues raised in the media. Because Hab co's reputation for integrity and transparency were considered to be strategically important and had been questioned, it was decided that the statement should also contain reassurances about these important themes.

Required:

- (a) Briefly explain 'related' and 'correlated' risks. Explore the correlation between legal risk and reputation risk for Hab co if it were to cancel its contract with Tesland co.** (10 marks)
- (b) Describe an environmental report, including its purpose and contents, and discuss the potential advantages of an environmental report for Hab co and its shareholders.** (10 marks)
- (c) Briefly explain how internal controls can be strategic in nature. Explain, using detailed examples from the case, why developing sound internal controls over the supply and processing of TY2 would be important if Hab co opted to build its own factory in Lowland.** (10 marks)
- (d) Draft the press release as discussed in the case. It should:**
 - (i) Define and explain the importance of 'integrity' and 'transparency' in the context of the case.** (6 marks)
 - (ii) Construct an argument against paying the bribe to the mayor of Baly from both business and ethical perspectives. Your ethical arguments should include both deontological and consequentialist perspectives.** (10 marks)

Professional marks will be awarded in part (d) for the format, tone, logical flow and persuasiveness of the press release.

(4 marks)
(50 marks)

Second Section
Answer two questions only

QUESTION (2):

Five years ago, Mr. Kamal was appointed chief executive officer (CEO) of Al Ahali Bank, one of the largest global banks. Mr Kamal 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 Al Ahali Bank looked forward to his appointment and a significant strengthening of the business.

One of the factors needed to secure Mr Kamal's services was his reward package. Prior to his acceptance of the position, Al Ahali Bank's remuneration committee (comprised entirely of non-executives) received a letter from MrKamal 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 Kamal'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 Al Ahali Bank that the individual details of his reward package were not considered important.

In addition, the remuneration committee received several letters from Al Ahali Bank's finance director, John Temba,saying, in direct terms, that they should offer Mr Kamal '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 Kamal and told the finance director they would take his advice and make sure they put a package together that would ensure Mr Kamal joined the bank.

Once in post, Mr Kamal 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 Al Ahali Bank. Shareholders voted to replace Kamal 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 Kamal was being 'rewarded for failure'. When Mr Kamal 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:

(a) Criticise the performance of Al Ahali Bank's remuneration committee in agreeing Mr Kamal's reward package.

(10 marks)

(b) 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 Kamal.

(10 marks)

(c) Construct an ethical case for Mr Kamal to voluntarily accept a reduction in his pension eligible for due in recognition of his failure as chief executive of Al Ahali Bank.

(5 marks)

(Total = 25 marks)

QUESTION (3):

Ahmed Hassan, the recently retired chief executive of Zodiak Company, a major listed company, was giving a speech reflecting on his career and some of the aspects of governance he supported and others of which he was critical. In particular, he believed that board committees were mainly ineffective. A lot of the ineffectiveness, he said, was due to the lack of independence of many non-executive directors (NEDs). He believed that it was not enough just to have the required number of non-executive directors; they must also be 'truly independent' of the executive board. It was his opinion that it was not enough to have no material financial connection with a company for independence: he believed that in order to be truly independent, NEDs should come from outside the industry and have no previous contact with any of the current executive directors.

In relation to risk committees, he said that in his experience, the company's risk committee had never stopped any risk affecting the company and because of this, he questioned its value. He said that the risk committee was 'always asking for more information, which was inconvenient' and had such a 'gloomy and pessimistic' approach to its task.

He asked, 'why can't risk committees just get on with stopping risk, and also stop making inconvenient demands on company management? Do they think middle managers have nothing else to do?' He viewed all material risks as external risks and so the risk committee should be looking outwards and not inwards.

Since retiring from Zodiak, Mr Ahmed had taken up a non-executive directorship of a smaller private company in his town. In a meeting with Mohamed Jamal, the new chief executive of Zodiak, Mr Mohamed Jamal said that whilst risk management systems were vital in large companies like Zodiak, fewer risk controls were needed in smaller companies.

Required:

- (a) Define 'independence' in the context of corporate governance and critically evaluate Mr Ahmed's comment that greater independence of non-executive directors is important in increasing the effectiveness of board committees.**
(8 marks)
- (b) Describe the roles of a risk committee and criticise Mr Ahmed's understanding of the risk committee in Zodiak Company.**
(9 marks)
- (c) Assess whether risk committees and risk mitigation systems are more important in larger companies, like Zodiak, than in smaller companies.**
(8 marks)
(25 marks)

QUESTION (4):

In a major policy speech, Government finance minister said that the audit and assurance industry's work should always be judged by the effect it has on public confidence in business. He said that it was crucial that professional services such as audit and assurance should always be performed in the public interest and that there should be no material threats to the assurer's independence. Enron and other corporate failures happened, He said, because some accountants didn't understand what it was to act in the public interest. He stressed that it was important that firms should not provide more than one service to individual clients. If a firm audited a client then, he said, it shouldn't provide any other services to that client.

Mr Murad, a financial journalist who had worked in audit and assurance for many years, was in the audience. He suggested that the normal advice on threats to independence was wrong. On the contrary in fact, the more services that a professional services firm can provide to a client the better, as it enables the firm to better understand the client and its commercial and accounting needs. The minister disagreed, saying that his views were a good example of professional services firms not acting in the public interest.

Mr Murad said that when he was a partner at a major professional services firm, he got to know his clients very well through the multiple links that his firm had with them. He said that he knew all about their finances from providing audit and assurance services, all about their tax affairs through tax consulting and was always in a good position to provide any other advice as he had acted as a consultant on other matters for many years including advising on mergers, acquisitions, compliance and legal issues. He became very good friends with the directors of client companies, he said. The clients, he explained, also found the relationship very helpful and the accounting firms did well financially out of it.

Another reporter in the audience argued with Mr Murad. Mr Hashim said that Mr Murad represented the 'very worst' of the accounting profession. He said that accounting was a 'biased and value laden' profession that served minority interests, was complicit in environmental degradation and could not serve the public interest as long as it primarily served the interests of unfettered capitalism. He said that the public interest was badly served by accounting, as it did not address poverty, animal rights or other social injustices.

Required

- (a) Explain, using accounting as an example, what 'the public interest' means as used by the Minister in his speech.**

(5 marks)

This requirement concerns ethical threats. It is very important for professional accountants to be aware of ethical threats and to avoid these where possible.

Required

- (b) (i) With reference to the case as appropriate, describe five types of ethical threat.**

(5 marks)

- (ii) Assess the ethical threats implied by Mr Murad's believes.**

(8 marks)

- (c) Assess Hashim's remarks about the accounting profession in the light of Gray, Owen & Adams' deep green (or deep ecologist) position on social responsibility.**

(7 marks)

(Total = 25 marks)

'End of question'