

Professional Level – Essentials Module

# Governance, Risk and Ethics

March/June 2016 – Sample Questions



**Time allowed**

Reading and planning: 15 minutes

Writing: 3 hours

This question 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 question 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.**

Think Ahead

**ACCA**

The Association of  
Chartered Certified  
Accountants

P1  
Paper

**This is a blank page.**  
**The question paper begins on page 3.**

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

- 1 In the city of Philo, the closure of a large factory released a large amount of land very close to the city centre which was bought by the Philo local government authority. As an area of high unemployment due to closures of heavy industry including shipbuilding and coal mining, Philo had an unemployment rate higher than the national average. As such, the local government authority was always keen to see new investments which would create high quality jobs. Although the former factory land had a potentially high commercial value if sold to housing developers, the local government authority offered the local university the chance to buy it for a favourable rate due to what it could offer the town as a whole. It was hoped that the university would buy the land, creating a new development called 'Science First' on the old factory site which would in turn create 500 jobs.

As a city, Philo was well known for its science and engineering history, with many innovations, inventions and science developments having been made in the city going back over 200 years. Philo University saw investment in science as strategic to its future and as a key part of its competitive advantage. The Philo local government authority discussed the possibility of developing the former factory site with the university. After a series of meetings between the university and the local government authority, the university bought the land, as co-owners with the local government authority, with the full support of the local authority for building laboratories and related buildings on the site. They agreed the name Science First for the development and jointly formed a company of the same name for the investment.

It was planned to build four large science laboratories on the site for medical, pharmacological and technology research. Science First Company also wanted to develop a cluster of science-based businesses on the site and offered discounted rents as well as negotiating lower local taxes, to attract these businesses to the site. One of these new businesses, Topscience Company, had received international attention because of a key breakthrough it had made in medical research. Topscience was very concerned about how its building would appear on promotional photographs and it noticed that just beyond the science park, and within a few metres of its new building, were a number of blocks of poor quality social housing, owned by the Philo local government authority and accommodating rental tenants. Topscience asked if the local government authority would require Science First Company to re-landscape the area around the flats and knock them down in favour of green spaces more in keeping, in Topscience's opinion, with the image of a science park. They suggested they would not be able to locate to the Science First development in Philo unless this was done.

Anxious not to be seen to be doing anything to hinder the park's development, the Philo local government authority agreed to Topscience's demands and issued a notice to quit for all of the local residents affected by the potential demolition of the flats. Upon hearing of the plan to demolish the flats, the head of the local residents' association, Ann Tang, was outraged. She criticised the Philo local government authority for a lack of fairness and transparency in their dealings with the residents. She said that the local authority was so concerned about the science park's development that it did not care about social housing residents and that this was a betrayal of the authority's ethical responsibilities. Ann Tang also said that if the flats were demolished, there would be a loss of a 'close-knit, effective and cohesive' community of people who did not deserve to lose their homes in this way, all for the sake of a science development in which they, the local residents, had no say and did not vote for.

Ann Tang also acquired some figures which showed that, in order to invest in the Science First Company, the local government authority had to take budgeted funding from other services including the cancellation of a proposed new public library in the area where Ann Tang lives. Local residents, who were excited about the new library development, planned to use the new library as a lending library, as a place to study, as a café where people could meet and enjoy time with friends, and as a place for other services to be provided including 'mums and toddlers', 'unemployment clubs' and art classes. The cancellation of this library development would also mean that the ten jobs in the library would not now be created.

In seeking to address the challenges from the residents' association and others, the local government authority asked the finance director of Science First Company, accountant Kathy Wong, to produce a balanced assessment of the contribution of the Science First development to the city and the region. The local government authority, co-owners of Science First Company, insisted that she produce a balanced assessment which could also be published for the benefit of local residents. As a director of the development, however, she felt she ought to produce a report which clearly showed the benefits of the park to the city of Philo. Accordingly, she produced a report which concentrated on the benefits to Philo of the Science First development, in terms of the creation of jobs, marginal revenues and improved reputation for both the university and the city. Kathy Wong's report concluded that the park was of substantial benefit and should be supported by the local government authority, by the university and by local residents, who, she argued, should understand the strategic benefits of the development to the city.

Ann Tang criticised Kathy Wong for not taking into account the costs to residents and other local services of the Science First development. She said that the true social cost of the development was negative because it threatened to destroy homes and it would entail the cancellation of the proposed library. It would also have a negative effect on local infrastructure, including the diversion of roads, footpaths and bus routes.

The Philo local government authority, as a democratic body, is controlled by elected representatives from a range of different political parties, each of whom represents a portion of the total city population. Despite their political differences, the majority of elected representatives strongly supported the Science First development.

Some of the elected representatives on the Philo local government authority decided that it was right to consider the various stakeholders in the Science First development. Some elected representatives, especially those representing residents around the development, wanted to minimise the damage to local communities. They decided that the three main stakeholders to be considered were the Science First Company, the residents' association and the potential library users.

The head of the Philo local government authority, Simon Forfeit, sought to address the concerns of the elected representatives in a meeting of the elected members in which he set out the case for why the Philo local government authority had so strongly supported the Science First development. He said he recognised that in allowing and encouraging the Science First development, it was clear there would be local problems to address, but that the strategic interests of the city of Philo required this development. The city's reputation as a science city would, in his view, be enhanced by the Science First development. He argued that public sector organisations had complicated objective-setting processes which have to prioritise some interests over others. He said that he 'can't please everybody all the time and in any planning decision there are winners and losers.'

Mr Forfeit said that a local government authority had many obligations and had to serve the interests of local taxpayers who fund its work, and also the people who use its services. At the same time, it had to act in the long-term strategic interests of the city, which was why it so strongly supported the Science First development. The quality of jobs attracted by the science site, being highly skilled and highly paid, meant that the local government authority had no choice but to support and invest in the development even though some of the effects on local residents might be perceived as negative. In addition to the 500 new jobs, which will be advertised locally, Mr Forfeit said that the site would also provide space for expansion of the businesses which locate to the site. Mr Forfeit said that in addition to Topscience, other companies attracted to the site included companies producing electric vehicles, advanced medical solutions and other companies in growth sectors.

**Required:**

- (a) (i) Analyse the stakeholder claims of Science First Company, the residents' association and the potential library users, using the Mendelow matrix to plot these three stakeholders in the Science First development.** (9 marks)

**(ii) Explain how the potential library users and residents' association might attempt to increase their influence as stakeholders in the Science First development.** (4 marks)
- (b) Critically evaluate the contribution to the public interest of the new Science First development to the city of Philo.** (10 marks)
- (c) Explain the role of accountants in society and criticise Science First Company's finance director, Kathy Wong, in her assessment of the Science First development.** (8 marks)

- (d) The head of the local authority was criticised by the residents' association for lacking transparency and fairness in its dealings with the residents.

**Required:**

**Draft a statement on behalf of the head of the Philo local government authority, for their website, which covers the following issues:**

- (i) **Explanations of transparency and fairness and their importance in public sector governance.** (6 marks)
- (ii) **An analysis of the complexities of performance measurement for public sector organisations and an explanation of how the 3Es model can be used for this purpose.** (9 marks)

Professional marks will be awarded in part (d) for flow, tone, persuasiveness and structure of the statement. (4 marks)

**(50 marks)**

## Section B – TWO questions ONLY to be attempted

- 2 Arthur Jellicoe has been the chief executive officer (CEO) of Scapa Holdings, a listed company, for over 15 years, during which time the company has been very successful in capturing market share and achieving levels of profitability well in excess of its direct competition. Much of this success has been credited specifically to the way Arthur has managed the company. So when he advised the board at its last meeting that he plans to retire at the end of the year, there was real concern about appointing his successor. Scapa Holdings is particularly aware that any uncertainty which may arise during the CEO transitional period could result in a fall in share price, which they clearly wish to avoid.

The remuneration policy at Scapa Holdings includes a provision for awarding significant share options to executive directors when the company attains high levels of performance. For many years the targets set by the remuneration committee have been exceeded, so Arthur has accumulated a large number of share options which he can exercise any time over the next year. As part of his retirement planning, Arthur has consulted with an independent financial adviser who has recommended that he exercises his share options before he retires because they will deliver a tax efficient capital gain which he can then invest for his future. Clearly it will be in Arthur's best interest to choose an exercise date when the share price is trading at its highest. So when a new contract opportunity was tabled by the sales director, which would clearly increase the company's share price this year, Arthur was an enthusiastic supporter. Unfortunately, the finance director advised the board that its bank loan contained a restrictive covenant requiring the company to maintain interest cover of four times its pre-tax profit. Although Scapa Holdings has always been able to meet this loan condition, the finance director is concerned that the further investment in the working capital needed for the proposed new contract presented a significant risk of breaching the loan covenant.

To address this issue the CEO suggested that inventory could be valued differently in order to report a higher profit figure, and thereby increase the level of interest cover. He further suggested that 'this minor policy change would not be opposed by shareholders' as it would undoubtedly increase the value of the share price. He also advised the board that he was sure that he could use his longstanding friendship with the engagement partner of Scapa Holdings' auditors, who he had trained with as an accountant many years ago, to convince the audit team to agree with the higher inventory valuation during the forthcoming audit.

### Required:

- (a) An inherent risk in any listed company is that its directors have the power to pursue their own personal interests, which may not be aligned with their fiduciary duties towards shareholders.

**Explain the term conflict of interest in this context, and using information from the scenario, discuss how Arthur Jellicoe's behaviour presents a clear conflict of interest, stating what course of action he should take.**

(8 marks)

- (b) **Describe the agency relationships at Scapa Holdings, and explain how clear accountability could increase trust between principal and agent thereby reducing agency costs.**

(9 marks)

- (c) **Explain the meaning of 'probity' when maintaining professional business relationships as described in the scenario, and criticise the ethical behaviour of Arthur Jellicoe with respect to probity.**

(8 marks)

**(25 marks)**

- 3** Angus Fortune, an ACCA qualified accountant, is a director of a medium-sized consultancy company and he heads up the business advisory division. Angus qualified 15 years ago and has worked for his current employer for nearly eight years, where he is viewed by his colleagues as a knowledgeable and experienced professional. His reputation for always offering good quality advice to clients, together with his work ethic and loyalty, earned him promotion to the board last year.

In recent discussions with Peter Wise, the managing director, it was agreed that as part of his continuous professional development (CPD) as a director, Angus should attend an overseas conference on tackling internet fraud, a line of business activity the company was keen to develop.

After the opening session, which gave delegates details of the content of the three-day conference, Angus realised that he already knew everything which was going to be covered from his private studies. So he decided instead to spend his time more productively at a local library reading up on issues which would directly help him with a forthcoming major assignment. He phoned Peter before leaving the conference explaining what he planned to do, but Peter said that he would still like him to attend the conference as he was bound to pick up new areas of useful and relevant knowledge. However, Angus still decided to leave after the morning coffee break.

He was observed leaving by one of the conference organisers, despite remaining signed in for the whole all day. At the start of Day 2, Angus returned to sign the attendance register again, but then immediately proceeded to leave the conference building. He was approached by the conference organiser who advised Angus that he really ought to report his absence. Angus explained to the conference organiser that he already knew much of the content of the conference, and so felt that it would be waste of his time if he stayed. Instead, he explained, he planned to spend the time more productively researching subject matter which better suited both his personal development and his company's needs.

On reflection, the conference organiser decided to report Angus's absence.

**Required:**

- (a) Evaluate the benefits of CPD to Angus Fortune, and describe the features of effective CPD.** (10 marks)
- (b) With reference to Kohlberg's theory of human moral development, describe conventional level reasoning and discuss how Kohlberg's conventional level arguments could be used to justify the conference organiser's decision to report his absence.** (8 marks)
- (c) Evaluate Angus's actions at the conference against the fundamental ethical principles which should have guided his behaviour as a professional accountant.** (7 marks)

**(25 marks)**

- 4 WSK produces chemicals for use in the agricultural sector, some which are highly toxic in both liquid and gaseous states. They need to be safely stored on site after processing until they are shipped out to customers either by road or rail.

Analysis of recently published data, detailing the frequency and impact of earthquakes around the world, suggest that the likelihood of a strong earthquake occurring in the area where WSK has its only manufacturing and chemical storage facility is high. This very serious claim was made by the operations director at a recent board meeting following consultation with the senior scientific team. It has always been recognised that the WSK factory was situated in an area where earthquakes could occur, but the area had not experienced any major tremors for several years.

The possibility of an earthquake which could destroy the WSK factory and then cause a major environmental incident was of grave concern to the board, who decided that it needed to be fully evaluated and then effectively managed. The board asked the scientific team to calculate the probability of a toxic chemical emission being caused by an earthquake together with the consequential effects on the local environment and population, many of whom depended on WSK for employment and commercial activity. However, the scientific team were unable to provide any objective analysis to support their initial claim, they merely offered their best guess of what they perceived the risk to be.

The board concluded that this was inadequate, so they tasked the internal audit team to conduct an environmental audit, and to determine WSK's environmental footprint.

**Required:**

- (a) **Evaluate the difficulties of risk perception, and describe the problems with the perception of risk shown by the scientific team at WSK.** (8 marks)
- (b) **Explain the stages and benefits to WSK of conducting an environmental audit, and assess the importance of then reporting good quality information to the board.** (10 marks)
- (c) **Explain the term environmental footprint, and assess how the activities of WSK contribute to its footprint.** (7 marks)

**(25 marks)**

**End of Question Paper**