Professional Level – Essentials Module

Governance, Risk and Ethics

March/June 2017 – Sample Questions

Time allowed 3 hours 15 minutes

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.

This question paper must not be removed from the examination hall.

Paper P1

Think Ahead ACCA

The Association of Chartered Certified Accountants

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The question paper begins on page 3.

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

1 The State Bank of Forenia (SBF) is the largest bank in Forenia with a very large asset base. However, many of its assets consist of what are known as 'derivative financial instruments' or 'securitised assets'. These are loan certificates held on loans made by 'third party' lenders to borrowers of long-term funds. Unfortunately, the original loans were made in highly volatile property markets where the solvency and credit worthiness of the original borrowers was uncertain, making them quite risky. In addition, the bank also lends considerable amounts of funds directly to domestic customers for a variety of purposes, many of them loans over longer term periods. The bank had a lower than recommended ratio of capital and reserves compared with its risk adjusted assets. This ratio is known as the 'capital adequacy ratio'. To make up any potential or temporary difference or 'shortfall' between the needs of borrowers and lenders, the bank was normally able to borrow funds through the Forenia interbank loan system (FILS), which was a fund made available by all banks in Forenia to help each other access short-term funds for their immediate liquidity needs.

The bank had engaged the same auditors for over 20 years. Each year the auditors approved SBF's going concern statement without qualification. The going concern statement verifies that the bank (and its auditors) is satisfied that it has adequate capital and reserves to meet its liquidity needs, that its assets have reliable values and that the bank is profitable enough to continue trading into the foreseeable future.

The audit partner on the SBF contract and SBF's finance director had trained as accountants together many years ago, and had remained good friends. The audit partner was aware of other banks operating similar business models, and with comparable portfolios of securities and assets to SBF, and knew that their auditors had consistently given these other banks a clean bill of health. However, the audit partner had occasionally, privately, expressed concerns to the finance director about SBF's capital adequacy, the reliability of the valuations of derivative financial instruments and the longer term sustainability of the bank's business model. Despite having expressed his private doubts over SBF's capital adequacy, and potential falls in asset yields, the audit partner had signed off SBF's accounts as a 'fair and faithful representation' at the most recent audit.

A prominent business journalist had recently begun reporting on worrying trends he had identified in the statements of financial positions and the asset and liability profiles of several Forenian banks, including SBF. He had noticed that these banks not only held asset portfolios for which the values might be questionable, but there was also a continuing reduction in their capital adequacy. He also investigated the role of the bank's auditors, and realised that these trends had not affected their view of the banks' going concern status.

The journalist was aware that banks should maintain adequate cash reserves to lend to other bank customers. At the same time, banks must have immediate access to short-term liquidity to fulfil requests for withdrawals of cash from their deposit holders, even in a situation where a significant proportion of customers wish to withdraw their funds at the same time.

As part of his investigation, the journalist interviewed the finance director of SBF, in an attempt to discuss SBF's financial position. Having received what he considered to be an inadequate response from the finance director, the journalist reported problems with SBF's financial position on national television. This created panic for customers of the bank, and created severe liquidity problems for SBF as deposit holders queued to take their money out of the bank. Panic amongst bank customers spread, affecting confidence in the banking system in Forenia as a whole.

Because of its immediate situation, SBF found it difficult to borrow sufficiently through the interbank lending system (FILS) and faced the prospect of liquidation. As a consequence, the government was forced to intervene urgently and rescue the bank by taking a 49% share in the bank in return for an injection of cash to increase the bank's liquidity. Once the bank had acquired renewed capital funding to continue trading, the bank's borrowers became satisfied that the bank was no longer in danger and the panic at the bank subsided.

The prime minister of Forenia subsequently appeared on national television to say that it was very important to restore confidence in the banks in Forenia, and to make a commitment to do all he could to promote the necessary reforms. In future, because of the introduction of a law passed by the Forenian parliament, banks would be required to report honestly and transparently on each of their material risks, including liquidity risk and about how these were likely to be managed. In addition, they would also have to report by law on their capital adequacy. The prime minister stated that the reforms would provide shareholders with the information they needed and restore longer term confidence in the banking sector.

After the immediate crisis was over, SBF's non-executive directors questioned the competence of SBF's auditors and their approval of the financial statements, despite the clear underlying financial weaknesses of the bank. The audit committee was also concerned about the independence of the external auditors, how long they had held the appointment and how close a relationship the auditors had with key executive directors, including the finance director. SBF's board voted to terminate the audit contract and put the audit out to tender (i.e. to let other audit firms bid for the audit contract). After the audit was put out to tender, the board appointed new auditors with whom nobody in the bank had any previous connections.

Additionally, the non-executive directors believed that the shareholders of SBF should be informed fully about the situation leading up the crisis at the bank. They recommended that their chairman should provide this explanation and give reassurances for the future in a statement on the bank's website, including a comment on how the directors of the bank had previously failed to meet their fiduciary duties to the shareholders and how they intended to address these weaknesses in future. The SBF chairman, Amy Tan, agreed that this would be necessary and she started to take advice from executive colleagues on how her statement should be worded, and how to make the bank become more financially sustainable in the future. This was seen as very important in reassuring the shareholders of SBF.

Another outcome of the crisis was a discussion amongst SBF board members about the impact of the business journalist's television report on SBF's financial position. Some board members believed that the journalist's reporting had been irresponsible, and that the original panic at the bank was unnecessary as well as harmful to the bank's reputation. SBF's chairman (Amy Tan) suggested that the board had to concede that the bank's capital position had not been adequate and that some of its assets which carried high risk had reduced in value. The chairman reminded the board that the bank was subject to rules, imposed by the stock exchange and other banking regulators, including the newly introduced statutory law on capital adequacy and accurate and transparent reporting.

Amy Tan also pointed out that there were other regulations and listing rules which the bank should have complied with, including reporting provisions and rules on going concern safeguards. Finally, Amy Tan emphasised how the internal auditors had obligations to report on compliance with external regulations as well as internal requirements, and also to report on any other issues which arise by exception.

A further outcome of the crisis at SBF was that the board decided on key changes in the interests of improved reporting and transparency within the bank. The executive board decided that instead of the current practice of it receiving audit and internal control reports directly, in future the bank's audit committee would receive these reports first in order to make unbiased recommendations, as is more usual. The main executive board would only receive audit and internal control reports after the audit committee had fully considered and reviewed them, and made recommendations for the board to consider. Indeed, the audit committee had been pressing for this change as it felt that the executive directors might wish to influence or even, in some instances, ignore some parts of internal audit reports. To prevent this possibility, the audit committee wanted to assess the real issues regarding internal audit and internal controls and present reasonable recommendations directly to the board of executive directors to act upon.

Required:

(a) Explain why internal audit is important at SBF. (10 marks)

(b) Explain why it would be more appropriate for the audit committee to review the internal audit report before it goes to the executive board. (6 marks)

(c) Explain why it was in SBF shareholders' interests for the bank to put the external audit contract out to tender and allow other audit firms to bid for the audit contract. (8 marks)

(d) As chairman of the board, draft a statement to the shareholders, for inclusion on the bank's website, which contains the following:

(i) An explanation of the board's fiduciary duty and how the bank failed its shareholders in respect of the board's fiduciary duty. (8 marks)

(ii) A discussion of the importance of making a reliable going concern statement to shareholders and to the stock exchange. (6 marks)

(iii) A discussion of the main risks which the SBF is exposed to, and how these can be managed to make SBF a more stable and sustainable bank in the future. (8 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 Honey bees are a vital natural resource which work hard to pollinate hundreds of different crops, but it has been observed in recent years that they have started to disappear at an alarming rate. This situation may be due to the overconsumption of honey which bee colonies need to feed their larvae and the key worker bees, which in turn feed future Queen bees with the royal jelly they need to create new colonies. Overconsumption of honey by humans will eventually impact significantly on the global food chain. To raise public awareness about the honey bee issue, Grunwald, a health food manufacturer, has developed a *Honeybuzz* brand using only a natural honey substitute, tying this initiative back to its core strategic mission. To show its commitment to the cause, Grunwald has agreed to donate a portion of proceeds from its *Honeybuzz* brand sales to research into the decline of the honey bee population.

Paul Zondas, a freelance investigative journalist, managed to infiltrate one of Grunwald's manufacturing facilities which produced *Honeybuzz* branded products, and claimed it continues to use honey in the production processes. Grunwald rebutted this claim and stated that not only does it have a robust corporate social responsibility (CSR) strategy but in developing the *Honeybuzz* brand it has adopted a strategic CSR approach to its business. John Ulrich, Grunwald's operations director, stated that the company has published integrated reports for the past three years, and all aspects of the reports have been independently audited. He further claimed that these social and environmental audits provided evidence that the *Honeybuzz* branded products were having a positive impact on Grunwald's environmental footprint and did not contain honey, contrary to Paul Zondas' claims.

Required:

(a) (i) Explain and evaluate the concepts of CSR strategy and strategic CSR, as they relate to Grunwald and its *Honeybuzz* brand. (8 marks)

(ii) Justify which position on social responsibility is being adopted by Grunwald in the context of the Gray, Owen & Adams classifications. (4 marks)

(b) Explain the nature of social and environmental audits, and evaluate the contribution these make to the assurance of the integrated reports published by Grunwald. (7 marks)

(c) Assess the environmental impacts which the *Honeybuzz* brand can have in terms of both Grunwald's environmental footprint and environmental reporting. (6 marks)

(25 marks)

3 A few months ago MegaMart, a major national retailer, uncovered a serious issue within its financial accounts. In accordance with local stock market regulation, MegaMart issued a profits warning statement detailing that its pre-tax profits for the last six months had been overstated by $250 million. As a result of this error, profits for the first half of the financial year were around 25% lower than forecast, and already well below initial expectations. When stock market trading opened, MegaMart's share price immediately fell by 12%, and it has not yet recovered.

The audit committee of MegaMart decided to engage a firm of accountants to investigate the reason for this massive discrepancy, and in doing so delayed the publication of its interim results by a month. Their preliminary findings stated that the MegaMart profit overstatement was due to the accelerated recognition of commercial income and the delayed accrual of costs. Further detailed investigations indicated internal financial reporting systems and associated internal controls were wholly inadequate, allowing significant errors to go unchecked.

Before MegaMart announced the results of investigations, they were leaked to the media. The alleged serious errors and the need for further external assurance were widely reported due to the scale of the irregularity and the importance of MegaMart to the national economy.

The board as a whole was heavily criticised, and at an extraordinary general meeting convened at the express wish of its major institutional shareholders, the chairman, the chief executive officer and the finance director were all asked to tender their resignations and the new board to establish a risk committee to ensure such problems would never arise in the future.

Required:

(a) Explain the responsibilities of the board of MegaMart for ensuring effective financial reporting and internal control systems, and explain how the work of a risk committee can help the board fulfil its responsibilities. (7 marks)

(b) Describe the objectives of internal control systems, and explain how meeting these could help prevent further misreporting or error at MegaMart. (8 marks)

(c) Explain the general principles of disclosure and communication which the board of MegaMart should follow when it briefs its shareholders. (10 marks)

(25 marks)

4 RMBE is licensed to operate a high-speed rail network directly linking several cities in the large country of Vinland. The government of Vinland heavily subsidises the rail network as it believes it to be critical infrastructure for the economic prosperity of this vast country. In return for the state finance, the government has set RMBE challenging performance targets, the results of which it is required to publish monthly, as well as explaining any significant variances to the transport ministry.

The board of RMBE acknowledges that severe delays or cancellations, even if caused by problems outside the company's direct control, present it with a risk to its reputation with the travelling public, and loss of financial subsidies from the government which allow it to charge its customers attractive, low prices. Therefore, RMBE proactively manages risk to ensure that customers receive the services they expect and demand by employing an enterprise risk management (ERM) framework. ERM aligns RMBE's corporate objectives with its key performance indicators and targets, clearly implying that it takes the management of risk very seriously. Indeed, the culture of putting the customer's needs first is embedded into everything RMBE does.

Recently, a weather-related train accident in an outlying area resulted in fatalities, casualties and major operational disruption on the RMBE rail network. The actions taken by managers at all levels of RMBE were highly commended, as it was recognised that their prompt and effective responses to this serious situation significantly reduced the number of deaths and injuries sustained. The coordination of emergency services meant that help was on the scene quickly.

The conclusions drawn from the findings of an independent accident investigation report accepted that although risks in operating a rail service could not be entirely eliminated, they should always be reduced to as low as reasonably practicable (ALARP).

Required:

(a) Describe how risk awareness could be embedded in RMBE's culture and values. (8 marks)

(b) Discuss the risks which RMBE is exposed to, and explain how the ALARP principle in risk assessment relates to impact and probability. (12 marks)

(c) Assess how RMBE uses risk management techniques to mitigate various types of business and financial risks which it faces. (5 marks)

(25 marks)

End of Question Paper