# Answers

**1 (a) Importance of internal audit at SBF**

Internal audit is important at SBF for many reasons, especially given its recent performance. Internal audit measures and monitors internal compliance issues and is therefore important for shareholders, especially those concerned about the going concern problems at SBF.

Internal audit ensures *compliance with regulatory norms* in the interests of stakeholders (including the regulators and the shareholders). For example, the rule on capital adequacy cannot be ignored and it is very important to the bank's stakeholders, including shareholders. Compliance is also expected by the stock exchange. Non-compliance might affect SBF's credit rating, which is also very important to the shareholders.

Internal audit is integral to the organisation's internal control system. Accordingly, it helps directors *set the tone for the internal environment* and will become part of the culture of the organisation. The effective functioning of the audit committee and the internal audit process leads staff to expect certain organisational norms. Internal audit signals the tone from the top and what is expected from staff in terms of performance and the types of behaviour which are acceptable and which are not.

*Internal audit monitoring activities involve inspecting the internal processes* used to determine the quality of the organisational systems and the robustness of the organisation's outcomes. Once SBF employees expect monitoring to take place, it becomes a normal part of the work culture. Their behaviour is influenced, and good behaviour becomes embedded in SBF's organisational culture and procedures.

Internal auditing should also ensure that *risks are regularly assessed*, meaning that risks are monitored and then assessed in terms of probability and impact. This is very important in terms of SBF management being aware of *all business risks* and ensuring their assessment is up-to-date. It also means that all risks are theoretically understood and there should be nothing which comes as a surprise to management. Once risks are assessed, strategies can be selected for the management of those risks, depending upon how each one is assessed.

*Internal auditing of control activities as they relate to issues of capital adequacy* are important to SBF shareholders. Control activities may underpin the confidence of shareholders concerned about the value of their holdings and the ability of the bank to meet its short-term liquidity needs. Adequate reporting should provide them with reassurance about the going concern status of the bank and the value of their investment within it. A robust internal audit function can assure shareholders that there are control activities in place, which safeguard the bank's assets and sources of value, including controls on transactions and anything else which ensures that management directives are actually carried out.

Finally, and more generally, internal audit also provides SBF shareholders with a *robust assessment of the internal processes* of the business. The efficiency and effectiveness of internal control systems are material considerations to shareholders when deciding on their investments.

**(b) Audit committee receiving the internal audit report before the board**

SBF's audit committee would need to receive the internal audit report before the board for the following reasons:

Most importantly, the primary reason why the audit committee receives the internal audit report first is *so the audit committee can see the quality (or not) of the bank's internal systems*. The reason SBF's audit committee would not want the internal audit report to go to the main board first is to allow them to assess the robustness of internal systems without having comments from the board to deal with at the same time. Comments from SBF's board might try to put critical reports in a positive light, which would be unfair to the shareholders. Shareholders have a right to know about anything which affects the long-term value of their shares, and any limitation on this right is not what they (the shareholders) would want.

SBF's audit committee would also need to see the *true state of external compliance* within the organisation, including compliance with the reporting, capital adequacy and other statutory provisions, as imposed by the regulator, the national parliament, and the stock exchange. This information is important for the shareholders and therefore, as the representatives of the shareholders, the audit committee must review it, and report on it, as necessary to the shareholders. This information may affect how shareholders value and price SBF, and accordingly, shareholders should be informed as necessary, without the board trying to influence the findings of such reports to protect themselves.

Additionally, SBF's audit committee needs to consider *internal compliance issues including internal requirements relating to SBF's asset portfolio*. The robustness of SBF's asset portfolio is very important to shareholders because it can affect the future income shareholders are likely to receive. A key area of concern for SBF's audit committee is what the *internal audit report says about the bank's overall approach to internal compliance issues*. If the internal audit report shows any problems with internal compliance, then that would be a negative signal to shareholders. The audit committee might decide to probe further and to challenge the executive directors on the laxity of the internal processes.

**(c) Putting the external audit out to tender**

There was a manifest *lack of independence* in the relationship between SBF and its auditor.

Private briefings between the audit partner and the finance director, which raised *serious issues about 'going concern' which were then not reported* or acted upon, was highly improper behaviour. Any material information should be reported to the shareholders, especially if it concerns the capital structure of the bank and if it affects the going concern status of the bank.

The fact that the finance director of the bank and the engagement partner were old friends *is an obvious threat to independence* and this relationship in itself compromised the shareholder value of the business. The number of private briefings without referring the issues to shareholders in the annual report is a manifestation of the lack of independence, and this was not in the interests of the shareholders.

The former audit partner was 'captured' by SBF's executive directors and as a result was unable to bring concerns to SBF's shareholders, especially those which were material to shareholder value. In particular, *auditor concerns over capital adequacy and the valuation of the bank's asset portfolio are all price-sensitive information to shareholders*. These should all be disclosed to shareholders, possibly in a statement by the chairman to the shareholders. Certainly, this information should not have been the subject of private briefings between the bank's audit partner and finance director, and then be left unresolved. In this situation, it was imperative that SBF should put the audit out to tender as a matter of urgency.

A new auditor would *also serve to reassure shareholders* that all of the material concerns would be reported to them. In corporate governance, it is vital that shareholders can rely on the external auditor to adequately serve their needs and insist that all material disclosures are made to furnish the shareholders with all relevant and material information.

**(d) (i) Bank's fiduciary duty**

Dear shareholders

The board is acutely aware of the duty to ensure that every decision it makes is in the interests of shareholders. The bank has a duty of care and trust to the shareholders, and this is the fiduciary duty it owes to those who fund the bank. It should be said that the board takes this responsibility very seriously. In respect of this, there are several points we would want to make.

On reflection, our relationship with our previous auditors became too close which was perhaps inevitable after such a long period. This situation was potentially a threat to objectivity and this, in turn, raises independence issues. Apparently auditors had privately expressed doubts about the capital adequacy of the bank and highlighted issues relating to our asset portfolio. This *information is highly price sensitive* and should have been reported to the shareholders.

The bank's audit committee also had *doubts over the independence of the previous external auditors*. This is a serious issue and it should have been reported. We regret that we did not put the audit contract out to tender sooner. The audit partner gave the bank a clean bill of health (reporting there were no issues relating to going concern), when it has now become evident that there were some doubts in this regard.

The value of SBF's asset portfolio was heavily dependent on the value of its *derivative loan instruments and there was some question over the long-term viability of these instruments*. There was also a high dependence on the intrinsic value of these instruments. The derivatives have subsequently reduced in value and, accordingly, shareholders should have been informed of these value reductions.

**(ii) Reliable going concern reporting**

Shareholders have a right to know all values which relate to their investment and to be informed about any reasonable doubts as to the reliability of these values. The concealment of relevant information (such as capital adequacy) would *represent a failure of the agency relationship between shareholders and directors*.

The going concern statement is a validation by the auditors on behalf of the directors that the bank's financial and economic position is sound and sustainable into the foreseeable future. That would involve giving an assurance to shareholders that the bank is not at risk of insolvency and the value of the bank's assets are reliable and reasonably secure. The confidence in going concern raises a number of agency issues. The first is that if there is any doubt about the going concern of a business such as SBF, the *shareholders have a right to know this so they can adjust their share portfolio accordingly*, perhaps by selling their shares in SBF.

Shareholders may also want to question the board about the disclosures in the annual report, *including the going concern statement*. This is an important element of the board's accountability to shareholders and these meetings exist for this very purpose: to hold boards to account. In SBF's general meetings, shareholders can ask any question and expect the board to provide convincing answers. These meetings are also important to satisfy the shareholders that no information has been withheld.

**(iii) Risks which might face SBF**

Because of the unfortunate events which have faced SBF in recent months, there are a number of risks which the bank faces and we must now address these urgently.

The most significant risk is *liquidity risk*. It was this risk, which created the problems at the time when the government intervened and these must be continually monitored and reported upon. Because this matters to the shareholders, it matters to the board, and we fully intend to ensure our internal controls will help prevent this in future. Were this risk to be realised (again), it would represent a serious going concern threat to SBF, so by continual monitoring, we intend to control this risk. Since the government has passed a law requiring SBF and other Forenian banks to report this risk, we will obviously do so in future. This risk will be considerably mitigated by our new, more transparent reporting system where the findings of internal control risk monitoring at the bank are reported to the audit committee to consider before recommendations are passed to the main board of directors to act upon.

The next most serious risk is *investment risk*. It is likely that if there is any repetition of the recent events, investors will lose confidence in the bank and reduce the number of SBF shares in their portfolios. Again, we need to communicate directly with shareholders, and to tell them what they need to know in order for them to make informed choices about their investments in SBF. I would suggest that open reporting to shareholders is imperative if confidence is to be restored. We also need to review our business model to ensure that we invest in more sustainable assets whose value can be more readily guaranteed and verified.

Another risk associated with failure to control the above risks is *reputation risk*. The bank has been severely criticised in the press and our investors and customers have rightly reacted negatively. Management of this risk requires a demonstration of competence and ongoing trust, and we must not waver in this regard. SBF has faced an unprecedented loss of reputation and this must be met head on with continued integrity and probity, ensuring full disclosure of capital adequacy and any problems we might be having with capital values and the security of assets and any potential deterioration in their value over time.

There is also the issue of *strategic risk*. It is very important that the bank fits in with its environment and strategic risks can affect the future of the bank. Strategic risks can affect the going concern status of SBF and must be taken seriously. Strategic risks include positioning risks, an inability to attract resources and to add value to those resources. Strategic risks can affect the going concern for shareholders, and so must be avoided or minimised as far as possible, for example, by having contingency plans to attract resources. To manage these risks, the bank should gradually strengthen its statement of financial position around a more sustainable portfolio of assets and liabilities and have greater controls around ensuring that the lending it makes, or the securitised assets it purchases are more dependable in economic terms. We also need to ensure we hold an adequate reserve of readily available liquid assets and to increase our capital adequacy ratio to meet our short-term needs and any contingencies we may face in the future.

To conclude, SBF recognises it has failed its shareholders in the past, has had a closer than usual relationship with the previous auditors and failed to properly uphold its fiduciary responsibilities to the shareholders, its customers, the government and to the wider public. We have now addressed this failing with the appointment of our new external auditors, with whom nobody in the company has any previous connection.

Looking to the future, our primary objective is to strengthen our financial performance and position by reviewing our asset base, considering more carefully to whom we lend and borrow from and gradually increasing our asset base through sustainable lending and trading within a formal framework of internal controls, reporting and risk management. We must also manage our major risks more effectively.

**Yours faithfully**

**Amy Tan**
**Chairman of the board**

**2 (a) (i) Corporate social responsibility (CSR) strategy**

A strategy is a long-term plan primarily focused on delivering a prescribed outcome. A CSR strategy specifically involves devising and then undertaking a series of deliberate steps in pursuance of a socially responsible agenda. To have a CSR strategy involves making choices in support of a specific cause, and implementing policies and procedures which will help to deliver the objectives.

It is clear from the scenario that the senior management team at Grunwald considers that the rapid decline in the honey bee population will have a devastating effect on the natural environment. The company finds itself in a position where it is able to actively promote the cause in the following ways:

– Promoting the rationale behind the artificial *Honeybuzz* brand to the wider population.
– Donating some of the proceeds from the sale of *Honeybuzz* branded produce to finance research into the reasons why honey bees are dying out.
– Introducing a natural honey substitute in the health food manufacturing process.

The incorporation of all of these activities into Grunwald's formal business plans effectively means that it has devised and implemented a CSR strategy.

**Strategic CSR**

Since CSR normally requires the commitment of significant financial resources, many companies try to reflect the core values and beliefs of the company's shareholders in CSR matters. Therefore, when CSR activities are undertaken with the motive of maximising the long-term economic benefit of the company, it can be better described as strategic CSR. The underlying assumption underpinning strategic CSR is that all company assets belong to the shareholders and so all activities, including CSR, should be configured in such a way as to enhance shareholder value.

At Grunwald, the development and promotion of the *Honeybuzz* brand will not only promote the cause of the honey bees but will vicariously improve the financial fortunes of the company and its shareholders. Indeed, for sufficient funds to be set aside for the research programme, a large volume of the *Honeybuzz* branded products will need to be sold. In fact, this correlation means that the more of the *Honeybuzz* brand products sold, the more money becomes available in support of the declining honey bees, so Grunwald has aligned its social responsibility aims with its core business objectives.

It could therefore be concluded that Grunwald has adopted a CSR strategy to publicise attention of the plight of the honey bees, but in doing so has benefited its own investors, so has also adopted a strategic CSR approach.

**(ii)** Gray, Owen & Adams, in their book *Accounting and Accountability*, described seven different viewpoints or positions which a company can adopt in relation to social responsibility. They assume that all organisations accept some degree of social responsibility, and with it accountability. At one extreme is the position held by a pristine capitalist organisation where there is only a duty towards shareholders. Pristine capitalists believe that if the focus is purely on maximising shareholder value, then the resultant higher level of taxation paid will benefit society, with decisions on how to use this money to address social and environmental issues best left to elected representatives. At the other end of the social responsibility spectrum are deep ecologists who do not believe that any humans (including shareholders) have any more rights than any other species on the planet. Deep ecologists would consider the plight of the honey bees as paramount and expect organisations like Grunwald to commit as much of its resources as necessary to resolve the situation.

From the scenario, it is clear that Grunwald is neither a pristine capitalist nor a deep ecologist, but has taken a position somewhere between these extremes. The position of Grunwald can be described as that of a social ecologist, since it recognises that its environmental footprint has exacerbated the honey bee shortage problem and it has a responsibility to take action to reduce this impact and attempt to remedy the situation. The CSR strategy Grunwald has decided to pursue will help to reverse the decline in the honey bee population, and in doing so benefit human life on the planet by enabling more honey bees to pollinate those crops essential to the global food chain.

**(b)** Social audits

Social auditing is the process which enables an organisation to both assess the measures it is taking to limit its negative social and economic impacts, while also demonstrating its commitment to making positive contributions and reversing any harm it may have caused through its business activities. This can be linked to its strategy by measuring the extent to which it has achieved those shared values and social responsibility objectives derived from its mission statement. The social audit provides additional information on corporate activities over and above that disclosed with the published financial statements.

At Grunwald, the social audit would identify and evaluate those health food products it manufactures and sells which have a negative impact on society. The reduction in the honey bee population will have an increasingly damaging effect on society at large if the bees are unable to pollinate sufficient crops used as foodstuffs. Grunwald has decided to take a series of positive actions, the impact of which will be eventually measured through a social audit and disclosed in the integrated report. Grunwald will be able to evaluate and report how effective its CSR strategy has been in reducing the impact of its social footprint.

Environmental audits

Environmental auditing aims to assess the impact an organisation has on its natural environment, and normally involves measurement against predetermined environmental standards, such as EMAS or ISO 14001. An environmental audit usually comprises three elements:

1. Agreeing what should be measured and how this is to be accomplished.
2. Measuring actual performance against the agreed measures.
3. Reporting findings, including any significant deviation from the standards or objectives.

Grunwald has not yet specified any basis of measuring the success of its CSR programmes, nor has it suggested a suitable timescale upon which any measurement should be based. It is clear that the sale of *Honeybuzz* branded products will result in money being put into honey bee research, so this can be objectively measured and targeted in any given accounting period. However, it is less obvious how creating greater public awareness of the honey bee problem through the new brand, and the outcome of funded research into how to reverse their decline can be objectively measured in success or failure terms for Grunwald for disclosure in its integrated report.

The inclusion of independently audited social and environmental programmes in integrated reports would provide the users of this information with greater assurance and confidence that the actions claimed by Grunwald were delivering positive results. The findings of the social audits could be included under the heading of *social capital* as it would indicate how the actions of Grunwald are having a positive impact on wider society. The environmental audit would be covered by *natural capital*, since this is where the impact of the company's activities on the ecosystem is disclosed.

**(c)** The *Honeybuzz* brand could have a number of environmental impacts on Grunwald's environmental footprint, including:

1. The development and promotion of the *Honeybuzz* brand to the wider population will help to increase public awareness of the honey bee problem. This could then encourage others to take further action and possibly eventually influence government policy in this area.

2. Pledging funds to research into honey bees and their welfare may ultimately help to find a resolution to the problem. The positive commitment to this cause evidenced by Grunwald's willingness to allocate shareholder funds to this research will have a very positive effect on its environmental footprint.

3. Changing a core health food manufacturing process through the introduction of a natural honey substitute demonstrates Grunwald's serious commitment to the plight of the honey bees. This decision will have resulted in the company incurring avoidable costs, but these could be viewed as an investment into its environmental footprint.

These would impact on Grunwald's environmental reporting in a number of ways:

1. It would counter the unsubstantiated claims made by Paul Zondas in his article by providing independent evidence that Grunwald is actually using a natural honey substitute in its *Honeybuzz* branded products. This would strengthen the company's CSR credentials with external stakeholders, and add to its strategic CSR benefits by potentially increasing sales from the positive publicity arising.
2. Access to this additional information would allow John Ulrich and other senior managers at Grunwald to make better resource allocation decisions. Apart from the positive CSR benefits which may arise, such decisions will enhance the risk management process and help to identify new business opportunities for the company to pursue. Therefore, environmental reporting can be seen as an aid to strategic CSR.
3. The information will be more aligned with shareholders and other stakeholder requirements, which may lead to enhanced trust and better engagement between Grunwald and all of its stakeholders, including its customers. Shareholders will be better informed and better able to assess the impact the CSR strategy is having on the business and their investment, in terms of risk and return.

**3 (a)** The responsibility of the board of MegaMart for ensuring effective financial reporting and internal control is fundamental for good corporate governance. In effect, the board must maintain effective control of the company's finances, operations, compliance and any other area of business activity. Although the accounting discrepancy which arose suggests a breach of financial controls, it is possible that other interconnected areas of the business activity may have contributed to the significant overstatement of profit.

Internal control systems relating to financial reporting

Although the board is ultimately responsible for setting appropriate policies on internal controls and obtaining the necessary assurances that the internal control system is functioning effectively, it can delegate this role to its newly established risk committee.

The risk committee at MegaMart would:

1. Approve the company's internal control strategy and policies. If such an approach had been previously followed at MegaMart, internal controls would have been established and it is unlikely that the overstatement of reported profit could have occurred.
2. Review reports on key internal control failures and monitor overall exposure on such failures. Again by highlighting those areas of activity which expose MegaMart to the highest level of internal control failures, management would have focused its attention on areas such as misreporting financial performance.
3. Assess the effectiveness of the company's internal control system. This is an ongoing activity that is likely to be tasked to internal auditors who would systematically determine if internal control systems were fit for purpose and likely to identify significant accounting discrepancies. The internal controls breach that resulted in the profits warning will worsen the performance of the company and so make the achievement of its objectives even less likely.
4. Provide early warning to the board of any emerging weaknesses in internal control from its operating environment. Unfortunately, the board of MegaMart only appeared to become aware of the misreported financial performance after it arose – when it was too late to avoid it occurring.
5. Comply with legislation and all regulations to which MegaMart is subject. The profits warning statement indicates that MegaMart is compliant with local stock market regulations, but the actual underlying misreporting infers a breach of legislation and a failure of internal controls.
6. Along with the audit committee, review the statement of internal control in compliance with corporate governance requirements before it is published in the annual report. If this had been undertaken correctly at MegaMart, it is very likely that the accounting discrepancy would have been avoided altogether, escaping the resultant financial distress to the company and its shareholders.
7. Ensure reliability of financial reporting, including the preparation of published financial statements. Clearly this failure of internal control is of great concern to the board of MegaMart, since the reported $250 million overstatement of profit has significantly damaged the company's reputation and its share price performance in the financial markets.

**(b)** The objectives of an internal control system are:

1. *The orderly and efficient conduct of business in conjunction with the risk management systems in place*. Controls mean that business processes and transactions take place without disruption and with less risk, which in turn should add to shareholder value.

   There is no indication from the scenario that the core retail operations of MegaMart are being conducted incorrectly. However, it is apparent that the finance department has some fundamental control problems which need to be addressed, and its actions have implications throughout the company. By strengthening the robustness of its financial controls, MegaMart is less likely to have a recurrence of recent events.

2. *The safeguarding of business assets, which include both tangibles and intangibles*. Controls are necessary to ensure these assets are optimally utilised and protected from misuse, fraud, misappropriation, or theft.

   Although the 'accelerated recognition of commercial income and the delayed accrual of costs' did not in itself amount to misuse of corporate assets, the resultant misreporting of these has severely damaged the company's reputation, a valuable intangible asset. The resultant fall in share price dramatically reduced shareholder value, which is only likely to recover when the market is confident in the internal control system at MegaMart.

   The error detected by internal controls could indicate possible operational or financial irregularities. Such breaches could include the use of unauthorised or incorrect accounting policies, which was evident from the findings of the report on MegaMart which stated 'internal financial reporting systems and associated internal controls were wholly inadequate, allowing significant errors to go unchecked.'

   Robust internal controls and disciplinary sanctions designed to deter anyone at MegaMart acting inappropriately in the future would help to prevent such a situation recurring. Alongside this, management controls should be implemented, comprising regular checks which would identify possible significant errors.

3. *The completeness and accuracy of accounting records*. Ensuring that all accounting transactions are fully and accurately recorded, that assets and liabilities are correctly identified and valued, and that all costs and revenues can be fully accounted.

   It is difficult to accept that an accounting discrepancy of $250 million could have arisen without senior management at MegaMart identifying it in its early stages, unless the accounting information presented was itself based on incomplete and inaccurate records. If all transactions are correctly recorded and appropriately accounted, then such a situation could not arise again in the future, so the accounting control systems need to be closely monitored and supervised going forward.

4. *The timely preparation of financial information which applies to both statutory reporting and management accounts for the facilitation of effective management decision-making.*

   The publication of MegaMart's interim results was delayed by a month because of the investigation into the misreporting, which would appear unavoidable under the circumstances. However, it is essential that financial information is presented to its users in a timely fashion and within strict deadlines as this will be a regulatory requirement. Therefore, the establishment of a reporting framework and cycle at MegaMart to meet statutory and management requirements is required. However, care should be taken to ensure that any resultant time pressure does not encourage inappropriate action or circumvention of controls, so adequate resources must be assigned to this task by the board.

In the aftermath of the recent accounting irregularity at MegaMart, it is necessary for the board to reflect on these objectives and adjust the internal control systems as suggested to prevent any further error.

**(c)** The general principles which should be used by the board of MegaMart to govern the disclosure and communication of company information to its shareholders are:

Transparency

Transparency refers to open and fair disclosure of information to shareholders, and not concealing information when it may affect their business decisions. In effect this means that openness should be the default position adopted by the board of MegaMart in terms of information provision to its shareholders. The fact that the results of the investigation were leaked to the media, suggests that this may have been how MegaMart shareholders became aware of the situation. The resultant extraordinary general meeting, where several board members were asked to resign, could possibly have been avoided if the board had adopted transparent procedures more quickly in its dealings with the shareholders.

Completeness

Information communicated to shareholders should not only meet the minimum statutory obligations in terms of published financial statements, but also include appropriate narrative such as directors' reports and operating and financial reviews. The board of MegaMart has a duty to provide shareholders with a complete picture of the company's affairs so that they can make informed decisions about their investment.

Information asymmetry

The board and management of MegaMart need access to far more information than do its shareholders, to enable them to effectively run the company on behalf of the shareholders. However, to overcome this information asymmetry, the board should implement good internal controls to ensure that shareholders are regularly informed about company affairs.

Inspire confidence

The communication and disclosure of relevant and reliable information can sometimes help reassure shareholders and the market that the company is being governed well, and this may significantly influence the share price of the company. The scenario indicates that the board of MegaMart complied with those stock market listing rules concerned with announcing profit warnings, but was slow in releasing the results of the investigation. However, making the information available exposed weaknesses at MegaMart, which undermined shareholders' confidence.

Confidentiality

There may be circumstances where the disclosure of sensitive and confidential information about the company's affairs may not be in the best interests of shareholders, particularly when such information may provide an advantage to competition. In such a case, the board is fully justified in not communicating this information to shareholders. However, the board must be prepared to explain its reasoning behind the non-disclosure, particularly if it later transpires any hidden actions damaged the firm, as was recently the case at MegaMart.

**4** **(a)** There are a number of ways in which risk awareness could be embedded into RMBE's culture and values, which are particularly important for a company operating in the rail industry.

Control environment

The strength of RMBE's control environment will significantly influence the ability of senior management to instil a more risk aware culture throughout this rail company. However, in order to embed risk awareness in the collective mind set at RMBE, the senior management team will need to clearly communicate the risk philosophy of the company as well as what is expected of all its employees. The publication of enterprise risk management (ERM) policies and procedures, together with statements of compliance, will help to make risk an integral aspect of RMBE's standard railway operating practices and its business culture.

Top level commitment

For the directors of RMBE, risk should be a prime consideration when developing business strategy. Shareholder value is largely driven by taking risks in pursuance of future growth opportunities, so care should be taken during the planning process to identify those risks which may prevent the achievement of corporate objectives and take appropriate mitigating action. One positive initiative which would clearly indicate top level commitment to greater risk awareness at RMBE would be to establish a board level risk committee to provide the necessary leadership and direction for the company. The risk committee would have the knowledge and authority to address rail industry specific risks.

Risk register

At an operational level, risk is an inherent feature of the core business activities of RMBE as a railway company, and it thus cannot be totally avoided. Employees must be aware that some operating processes are higher risk than others and be constantly vigilant about them. A risk register which lists and prioritises the main risks which the company faces can help employees decide which risks need most attention. The register can then be used as an objective and consistent basis to manage risk, committing sufficient resources as necessary and providing a holistic view of how risk is being managed throughout RMBE.

Human resource management

Culture has been described as *the way we do things around here*, so if greater risk awareness is to become a key feature of the RMBE culture, it needs to be inculcated into all aspects of human resource management, including:

(i) Individual job descriptions which should be drawn up with a greater emphasis on the duty of all employees to recognise and act on risks which may arise in their area of operations, particularly health and safety risk.

(ii) Induction programmes for new employees to include detail of RMBE's ERM initiatives so that risk becomes ingrained in employee behaviours from the outset.

(iii) Regular training workshops for existing staff to reinforce the key elements of the risk management philosophy and ERM processes, particularly pertinent to running a rail business.

(iv) Individual performance appraisals to evaluate objectives relating to risk. This way risk management will be considered a key feature of staff appraisal and reward systems, and so become more important to all of the railway employees.

**(b)** The risks currently facing RMBE include:

Health and safety risk

This is the potential source of harm or adverse health effect on a person or persons directly impacted by the operation of the organisation. This is particularly relevant to a business like RMBE, where its passengers are transported at high speed along a railway network linking cities throughout Vinland. The inherent risks of rail travel in remote areas significantly increases the danger to safety to which RMBE's passengers and employees are exposed.

Political risk

This refers to both the stability of a government, and the degree that it chooses to intervene in business activities. There is no suggestion that the Vinland government is likely to change in the foreseeable future. However, its recognition that the railway system is a key economic resource for the country by offering financial subsidies means that RMBE is highly dependent on it as a major stakeholder in its business. Failure to achieve the challenging performance targets set by the Vinland transport ministry could result in the risk of a significant reduction in income for RMBE, and all that entails for its core operations.

**Regulatory risk**

Such risks arise from those specific regulations which directly impact on the operation of an organisation. RMBE holds a licence to deliver a safe and reliable railway service to the paying public of Vinland. The recent unfortunate accident and the findings of the consequential independent report may result in additional safety regulations which could impact on the systems, operations, resources and investment plans for RMBE.

**Reputation risk**

This is the potential harm to an organisation's reliance an organisation has on its brand, image and standing with the public at large. The fatalities and casualties which occurred from the tragic accident may result in negative publicity and adverse public attitudes towards RMBE. If passengers believe that the RMBE service is unsafe, they may opt for alternative forms of transport, and this would in turn harm the company's financial and competitive position.

**Technology risk**

This arises from those possible changes in the technology essential to support ongoing business operations. The accident investigation report may recommend that RMBE invests in new safety equipment, rolling stock or even track to avoid a recurrence. Apart from the additional cost which would be incurred, the introduction of this new technology could negatively impact on the operational performance of RMBE in the short term. This could then affect the level of subsidy it receives as well as the reliability of its reputation with passengers.

**Market risk**

Represents the risk of potential losses on capital markets from the change in value or volatility of share price. The market risk at RMBE is influenced by:

(i) Operational performance, and its ability to meet the pre-determined performance financial targets.
(ii) Sourcing the necessary finance from capital markets to meet its investment plans.
(iii) Maintaining sufficient liquidity for the day-to day running of the business.
(iv) Obtaining the required resource inputs to deliver a reliable and safe rail service to its customers.

**Financial risk**

This is a general term which describes a company's reduction in revenue streams and profits, or even the risk of incurring a loss. As a railway service company, RMBE is heavily reliant on fare paying passengers as its primary source of finance, so any reduction in passenger numbers is likely to impact heavily on its financial performance particularly as it is likely to have a high proportion of fixed operating costs. Compounding this with the risk of losing state subsidies for under-performance makes RMBE very sensitive to financial risk.

**The ALARP principle**

The primary focus at RMBE will be to reduce risk to a tolerable level rather than eliminate it, because in market based systems managed risk-taking is fundamental to success and profit generation. As a general principle, the higher the level of risk, measured in terms of its impact and probability, the less acceptable it will be to the company.

For a rail business like RMBE, certain aspects of its core activities could be viewed as potentially hazardous and even dangerous, exemplified by the recent weather-related accident on a remote part of the rail network which resulted in casualties. It is clear that such risks cannot be completely avoided, but that they can be reduced to an acceptable level by investment in infrastructure, safety systems and support services. In effect, the level of acceptable risk becomes a trade-off between the assessment of the likelihood and impact of risk materialising and the cost to RMBE of taking action to mitigate it, such as a decision not to run rail services during short periods of extreme weather.

National legislation in Vinland and safety regulations governing the operation of railways will stipulate the minimum acceptable standards with which RMBE must comply. The role of the board of RMBE is to decide what level of risk is as low as reasonably practicable (ALARP) for it to operate within the law and at a safe level expected by its passengers and regulators.

The residual risk which remains after the necessary action has been taken needs to be subject to constant review. This is because of the dynamic nature of the environment in which RMBE operates, where risks can change both in terms of their severity and the probability of them arising, so management may need to regularly refine and update operational practices. Indeed, it is possible that the level of residual risk may no longer be deemed as low as reasonably practicable, so alternative internal control actions will be required. An example could be when extreme weather conditions occur more frequently, so extra measures are necessary to protect the rail track allowing services to continue to run.

**(c)** RMBE can use techniques to mitigate the various risks it faces as follows:

**Training sessions**

Compulsory awareness training for all operational staff will help them to identify health and safety risks before they become a potential hazard. Regular and structured planned maintenance of trains, track and signalling equipment will reduce the likelihood of accidents and injury. Standard operating procedures should to be designed and implemented with the safety of RMBE's passengers and staff at their core.

### Enterprise risk management (ERM)

RMBE employs an ERM framework to align the corporate objectives which arise from its strategic plans with its key performance indicators and agreed pre-determined targets. This approach should mitigate a number of risks identified, including political risk and market risk. The setting of targets orientates the business culture towards maintaining high levels of operational performance, but in a risk managed environment.

### Marketing

The marketing orientation advocated by the stated policy of 'putting the customer's needs first' suggests that RMBE is aware of the critical importance of its paying customers in all of its business operations. Such an awareness will help to mitigate the reputation risk of the company as well as a significant element of its financial risk. The dependence on government subsidies to keep passenger fares at a competitive level has its own inherent risks, but indicates the commitment of RMBE to offer its customers value for money.

### Performance information

The publishing of RMBE's actual performance against its pre-agreed targets every month focuses management attention on the necessity to maintain consistently high standards. This approach could reduce technology risk, since there would be a need to regularly upgrade systems and invest in new technology simply to achieve the required standard. The additional requirement to explain any significant variances against target to the transport ministry is an added motivation to the board of RMBE to manage business performance effectively.

### Contingency planning

RMBE's management was highly commended for the speedy and effective action taken in response to the recent serious incident, as it significantly reduced the number of fatalities and injuries sustained. The scenario implies that by employing its internal control systems, RMBE was able to coordinate emergency services in a remote part of the country. This report would have helped to mitigate RMBE's reputation risk with the general public, and reduce the risk of regulatory action by the authorities.

**1** **(a)** 2 marks for evidence of understanding of internal audit (anywhere in the answer).
2 marks for each relevant point as to why SBF needs internal audit.
(10 marks)

**(b)** 2 marks for each relevant point of why the audit committee should receive the internal audit report.
(6 marks)

**(c)** 2 marks for each relevant point on the importance of re-tendering the external audit contract.
(8 marks)

**(d)** **(i)** 2 marks for explanation of fiduciary duty. 2 marks for each relevant point on the failure of fiduciary duty (max 8 marks).
(8 marks)

**(ii)** 2 marks for each relevant point discussing the importance of making a reliable going concern statement.
(6 marks)

**(iii)** 2 marks for each relevant risk explained in the context of the scenario and for how they can be managed in the future.
(8 marks)

Professional marks
(4 marks)

**2** **(a)** **(i)** Up to 4 marks for an evaluation of CSR strategy as it relates to Grunwald/*Honeybuzz*.
Limited to 2 marks if not explained in relation to Grunwald/*Honeybuzz* [max 4 marks].
Up to 4 marks for an evaluation of strategic CSR as it relates to Grunwald/*Honeybuzz.*
Limited to 2 marks if not explained in relation to Grunwald/*Honeybuzz* [max 4 marks].
(8 marks)

**(ii)** Up to 2 marks for a general description of the Gray, Owen & Adams perspectives.
Up to 3 marks justified description of the Grunwald position.
Limit to 1 mark if not justified.
(4 marks)

**(b)** Up to 2 marks for the general explanation of a social audit.
Up to 2 marks for evaluating how social audits enhance Grunwald's integrated reports [max 4 marks].
Up to 2 marks for the general explanation of an environmental audit.
Up to 2 marks for evaluating how environmental audits enhance Grunwald's integrated reports [max 4 marks].
(7 marks)

**(c)** Up to 2 marks for each environmental impact on Grunwald's footprint.
Limited to 1 mark if not assessed in relation to Grunwald [max 4 marks].
Up to 2 marks for each environmental impact on Grunwald's reporting.
Limited to 1 mark if not assessed in relation to Grunwald [max 4 marks].
(6 marks)

**3** **(a)** 2 marks for overall responsibility of the board of MegaMart.
1 mark for each contribution from the risk committee.
(7 marks)

**(b)** 1 mark for each internal control objective described.
Up to 2 marks for explaining how each prevents misreporting or error.
(8 marks)

**(c)** Up to 2 marks for each disclosure or communication principle explained.
Limited to 1 mark if not specific to MegaMart.
(10 marks)

**4** **(a)** 2 marks for each descriptive point on how a risk aware culture could be embedded.
Limited to 1 mark if not specific to RMBE.

(8 marks)

**(b)** Up to 2 marks for each risk recognised and analysed [max 8 marks].
Limited to 1 mark if not specific to RMBE.
Up to 2 marks for each ALARP point explained [max 6 marks].

(12 marks)

**(c)** Up to 2 marks for each technique identified and assessed.
Limited to 1 mark if not specific to risks faced by RMBE.

(5 marks)