

Professional Level – Essentials Module

Professional Accountant

Monday 10 December 2007

Time allowed

Reading and planning: 15 minutes

Writing: 3 hours

This 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 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.

The Association of Chartered Certified Accountants

Paper P1



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

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

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

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

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

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

The board discussed the options open to it. The chairman, who was also a qualified accountant, was Tim Blake. He began by expressing serious concern about the overestimation and then invited the board to express views freely. Gary Howells, the operations director, said that because disclosing the error to the market would be so damaging, it might be best to keep it a secret and hope that new reserves can be found in the near future that will make up for the shortfall. He said that it was unlikely that this concealment would be found out as shareholders trusted WM and they had many years of good investor relations to draw on. Vanda Monroe, the finance director, reminded the board that the company was bound to certain standards of truthfulness and transparency by its stock market listing. She pointed out that they were constrained by codes of governance and ethics by the stock market and that colleagues should be aware that WM would be in technical breach of these if the incorrect estimation was concealed from investors. Finally, Martin Chan, the human resources director, said that the error should be disclosed to the investors because he would not want to be deceived if he were an outside investor in the company. He argued that whatever the governance codes said and whatever the cost in terms of reputation and market value, WM should admit its error and cope with whatever consequences arose. The WM board contains three non-executive directors and their views were also invited.

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

Required:

- (a) Define 'transparency' and evaluate its importance as an underlying principle in corporate governance and in relevant and reliable financial reporting. Your answer should refer to the case as appropriate. (10 marks)
- (b) Explain Kohlberg's three levels of moral development and identify the levels of moral development demonstrated by the contributions of Gary Howells, Vanda Monroe and Martin Chan. (12 marks)
- (c) Critically discuss FOUR principal roles of non-executive directors and explain the potential tensions between these roles that WM's non-executive directors may experience in advising on the disclosure of the overestimation of the mallerite reserve. (12 marks)
- (d) Draft a letter for Tim Blake to send to WM's investors to include the following:
- (i) why you believe robust internal controls to be important; and
 - (ii) proposals on how internal systems might be improved in the light of the overestimation of mallerite at WM.

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

(16 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

- 2 The risk committee at Southern Continents Company (SCC) met to discuss a report by its risk manager, Stephanie Field. The report focused on a number of risks that applied to a chemicals factory recently acquired by SCC in another country, Southland. She explained that the new risks related to the security of the factory in Southland in respect of burglary, to the supply of one of the key raw materials that experienced fluctuations in world supply and also an environmental risk. The environmental risk, Stephanie explained, was to do with the possibility of poisonous emissions from the Southland factory.

The SCC chief executive, Choo Wang, who chaired the risk committee, said that the Southland factory was important to him for two reasons. First, he said it was strategically important to the company. Second, it was important because his own bonuses depended upon it. He said that because he had personally negotiated the purchase of the Southland factory, the remunerations committee had included a performance bonus on his salary based on the success of the Southland investment. He told Stephanie that a performance-related bonus was payable when and if the factory achieved a certain level of output that Choo considered to be ambitious. 'I don't get any bonus at all until we reach a high level of output from the factory,' he said. 'So I don't care what the risks are, we will have to manage them.'

Stephanie explained that one of her main concerns arose because the employees at the factory in Southland were not aware of the importance of risk management to SCC. She said that the former owner of the factory paid less attention to risk issues and so the staff were not as aware of risk as Stephanie would like them to be. 'I would like to get risk awareness embedded in the culture at the Southland factory,' she said.

Choo Wang said that he knew from Stephanie's report what the risks were, but that he wanted somebody to explain to him what strategies SCC could use to manage the risks.

Required:

- (a) Describe four strategies that can be used to manage risk and identify, with reasons, an appropriate strategy for each of the three risks mentioned in the case. (12 marks)
- (b) Explain the meaning of Stephanie's comment: 'I would like to get risk awareness embedded in the culture at the Southland factory.' (5 marks)
- (c) Explain the benefits of performance-related pay in rewarding directors and critically evaluate the implications of the package offered to Choo Wang. (8 marks)

(25 marks)

3 At a recent international meeting of business leaders, Seamus O'Brien said that multi-jurisdictional attempts to regulate corporate governance were futile because of differences in national culture. He drew particular attention to the Organisation for Economic Co-operation and Development (OECD) and International Corporate Governance Network (ICGN) codes, saying that they were, 'silly attempts to harmonise practice'. He said that in some countries, for example, there were 'family reasons' for making the chairman and chief executive the same person. In other countries, he said, the separation of these roles seemed to work. Another delegate, Alliya Yongvanich, said that the roles of chief executive and chairman should always be separated because of what she called 'accountability to shareholders'.

One delegate, Vincent Viola, said that the right approach was to allow each country to set up its own corporate governance provisions. He said that it was suitable for some countries to produce and abide by their own 'very structured' corporate governance provisions, but in some other parts of the world, the local culture was to allow what he called, 'local interpretation of the rules'. He said that some cultures valued highly structured governance systems while others do not care as much.

Required:

- (a) Explain the roles of the chairman in corporate governance.** (5 marks)
- (b) Assess the benefits of the separation of the roles of chief executive and chairman that Alliya Yongvanich argued for and explain her belief that 'accountability to shareholders' is increased by the separation of these roles.** (12 marks)
- (c) Critically evaluate Vincent Viola's view that corporate governance provisions should vary by country.** (8 marks)

(25 marks)

- 4 When a prominent football club, whose shares were listed, announced that it was to build a new stadium on land near to its old stadium, opinion was divided. Many of the club's fans thought it a good idea because it would be more comfortable for them when watching games. A number of problems arose, however, when it was pointed out that the construction of the new stadium and its car parking would have a number of local implications. The local government authority said that building the stadium would involve diverting roads and changing local traffic flow, but that it would grant permission to build the stadium if those issues could be successfully addressed. A number of nearby residents complained that the new stadium would be too near their homes and that it would destroy the view from their gardens. Helen Yusri, who spoke on behalf of the local residents, said that the residents would fight the planning application through legal means if necessary. A nearby local inner-city wildlife reservation centre said that the stadium's construction might impact on local water levels and therefore upset the delicate balance of animals and plants in the wildlife centre. A local school, whose pupils often visited the wildlife centre, joined in the opposition, saying that whilst the school supported the building of a new stadium in principle, it had concerns about disruption to the wildlife centre.
- The football club's board was alarmed by the opposition to its planned new stadium as it had assumed that it would be welcomed because the club had always considered itself a part of the local community. The club chairman said that he wanted to maintain good relations with all local people if possible, but at the same time he owed it to the fans and the club's investors to proceed with the building of the new stadium despite local concerns.

Required:

- (a) **Define 'stakeholder' and explain the importance of identifying all the stakeholders in the stadium project.** (10 marks)
- (b) **Compare and contrast Gray, Owen and Adams's 'pristine capitalist' position with the 'social contractarian' position. Explain how these positions would affect responses to stakeholder concerns in the new stadium project.** (8 marks)
- (c) **Explain what 'fiduciary responsibility' means and construct the case for broadening the football club board's fiduciary responsibility in this case.** (7 marks)

(25 marks)

End of Question Paper