

Professional Level – Essentials Module

# Professional Accountant

Monday 9 June 2008

**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

The ACCA logo consists of the letters 'ACCA' in a bold, white, sans-serif font, centered within a solid black rectangular background.

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

- 1 Rowlands & Medeleev (R&M), a major listed European civil engineering company, was successful in its bid to become principal (lead) contractor to build the Giant Dam Project in an East Asian country. The board of R&M prided itself in observing the highest standards of corporate governance. R&M's client, the government of the East Asian country, had taken into account several factors in appointing the principal contractor including each bidder's track record in large civil engineering projects, the value of the bid and a statement, required from each bidder, on how it would deal with the 'sensitive issues' and publicity that might arise as a result of the project.

The Giant Dam Project was seen as vital to the East Asian country's economic development as it would provide a large amount of hydroelectric power. This was seen as a 'clean energy' driver of future economic growth. The government was keen to point out that because hydroelectric power did not involve the burning of fossil fuels, the power would be environmentally clean and would contribute to the East Asian country's ability to meet its internationally agreed carbon emission targets. This, in turn, would contribute to the reduction of greenhouse gases in the environment. Critics, such as the environmental pressure group 'Stop-the-dam', however, argued that the project was far too large and the cost to the local environment would be unacceptable. Stop-the-dam was highly organised and, according to press reports in Europe, was capable of disrupting progress on the dam by measures such as creating 'human barriers' to the site and hiding people in tunnels who would have to be physically removed before proceeding. A spokesman for Stop-the-dam said it would definitely be attempting to resist the Giant Dam Project when construction started.

The project was intended to dam one of the region's largest rivers, thus creating a massive lake behind it. The lake would, the critics claimed, not only displace an estimated 100,000 people from their homes, but would also flood productive farmland and destroy several rare plant and animal habitats. A number of important archaeological sites would also be lost. The largest community to be relocated was the indigenous First Nation people who had lived on and farmed the land for an estimated thousand years. A spokesman for the First Nation community said that the 'true price' of hydroelectric power was 'misery and cruelty'. A press report said that whilst the First Nation would be unlikely to disrupt the building of the dam, it was highly likely that they would protest and also attempt to mobilise opinion in other parts of the world against the Giant Dam Project.

The board of R&M was fully aware of the controversy when it submitted its tender to build the dam. The finance director, Sally Grignard, had insisted on putting an amount into the tender for the management of 'local risks'. Sally was also responsible for the financing of the project for R&M. Although the client was expected to release money in several 'interim payments' as the various parts of the project were completed to strict time deadlines, she anticipated a number of working capital challenges for R&M, especially near the beginning where a number of early stage costs would need to be incurred. There would, she explained, also be financing issues in managing the cash flows to R&M's many subcontractors. Although the major banks financed the client through a lending syndicate, R&M's usual bank said it was wary of lending directly to R&M for the Giant Dam Project because of the potential negative publicity that might result. Another bank said it would provide R&M with its early stage working capital needs on the understanding that its involvement in financing R&M to undertake the Giant Dam Project was not disclosed. A press statement from Stop-the-dam said that it would do all it could to discover R&M's financial lenders and publicly expose them. Sally told the R&M board that some debt financing would be essential until the first interim payments from the client became available.

When it was announced that R&M had won the contract to build the Giant Dam Project, some of its institutional shareholders contacted Richard Markovnikoff, the chairman. They wanted reassurance that the company had fully taken the environmental issues and other risks into account. One fund manager asked if Mr Markovnikoff could explain the sustainability implications of the project to assess whether R&M shares were still suitable for his environmentally sensitive clients. Mr Markovnikoff said, through the company's investor relations department, that he intended to give a statement at the next annual general meeting (AGM) that he hoped would address these environmental concerns. He would also, he said, make a statement on the importance of confidentiality in the financing of the early stage working capital needs.

(a) Any large project such as the Giant Dam Project has a number of stakeholders.

**Required:**

(i) Define the terms 'stakeholder' and 'stakeholder claim', and identify from the case **FOUR** of R&M's external stakeholders as it carries out the Giant Dam Project; (6 marks)

(ii) Describe the claim of each of the four identified stakeholders. (4 marks)

(b) Describe a framework to assess the risks to the progress of the Giant Dam Project. Your answer should include a diagram to represent the framework. (6 marks)

(c) Using information from the case, assess **THREE** risks to the Giant Dam Project. (9 marks)

(d) Prepare the statement for Mr Markovnikoff to read out at the AGM. The statement you construct should contain the following.

(i) A definition and brief explanation of 'sustainable development'; (3 marks)

(ii) An evaluation of the environmental and sustainability implications of the Giant Dam Project; (8 marks)

(iii) A statement on the importance of confidentiality in the financing of the early stage working capital needs and an explanation of how this conflicts with the duty of transparency in matters of corporate governance. (6 marks)

Professional marks for layout, logical flow and persuasiveness of the statement. (4 marks)

(e) Internal controls are very important in a complex civil engineering project such as the Giant Dam Project.

**Required:**

**Describe the difficulties of maintaining sound internal controls in the Giant Dam Project created by working through sub-contractors.** (4 marks)

**(50 marks)**

**Section B – TWO questions ONLY to be attempted**

- 2 It was the final day of a two-week-long audit of Van Buren Company, a longstanding client of Fillmore Pierce Auditors. In the afternoon, Anne Hayes, a recently qualified accountant and member of the audit team, was following an audit trail on some cash payments when she discovered what she described to the audit partner, Zachary Lincoln, as an ‘irregularity’. A large and material cash payment had been recorded with no recipient named. The corresponding invoice was handwritten on a scrap of paper and the signature was illegible.

Zachary, the audit partner, was under pressure to finish the audit that afternoon. He advised Anne to seek an explanation from Frank Monroe, the client’s finance director. Zachary told her that Van Buren was a longstanding client of Fillmore Pierce and he would be surprised if there was anything unethical or illegal about the payment. He said that he had personally been involved in the Van Buren audit for the last eight years and that it had always been without incident. He also said that Frank Monroe was an old friend of his from university days and that he was certain that he wouldn’t approve anything unethical or illegal. Zachary said that Fillmore Pierce had also done some consultancy for Van Buren so it was a very important client that he didn’t want Anne to upset with unwelcome and uncomfortable questioning.

When Anne sought an explanation from Mr Monroe, she was told that nobody could remember what the payment was for but that she had to recognise that ‘real’ audits were sometimes a bit messy and that not all audit trails would end as she might like them to. He also reminded her that it was the final day and both he and the audit firm were under time pressure to conclude business and get the audit signed off.

When Anne told Zachary what Frank had said, Zachary agreed not to get the audit signed off without Anne’s support, but warned her that she should be very certain that the irregularity was worth delaying the signoff for. It was therefore now Anne’s decision whether to extend the audit or have it signed off by the end of Friday afternoon.

**Required:**

- (a) **Explain why ‘auditor independence’ is necessary in auditor-client relationships and describe THREE threats to auditor independence in the case.** (9 marks)
- (b) Anne is experiencing some tension due to the conflict between her duties and responsibilities as an employee of Fillmore Pierce and as a qualified professional accountant.

**Required:**

- (i) **Compare and contrast her duties and responsibilities in the two roles of employee and professional accountant.** (6 marks)
- (ii) **Explain the ethical tensions between these roles that Anne is now experiencing.** (4 marks)
- (c) **Explain how absolutist (dogmatic) and relativist (pragmatic) ethical assumptions would affect the outcome of Anne’s decision.** (6 marks)

**(25 marks)**

- 3** Mary Hobbes joined the board of Rosh and Company, a large retailer, as finance director earlier this year. Whilst she was glad to have finally been given the chance to become finance director after several years as a financial accountant, she also quickly realised that the new appointment would offer her a lot of challenges. In the first board meeting, she realised that not only was she the only woman but she was also the youngest by many years.

Rosh was established almost 100 years ago. Members of the Rosh family have occupied senior board positions since the outset and even after the company's flotation 20 years ago a member of the Rosh family has either been executive chairman or chief executive. The current longstanding chairman, Timothy Rosh, has already prepared his slightly younger brother, Geoffrey (also a longstanding member of the board) to succeed him in two years' time when he plans to retire. The Rosh family, who still own 40% of the shares, consider it their right to occupy the most senior positions in the company so have never been very active in external recruitment. They only appointed Mary because they felt they needed a qualified accountant on the board to deal with changes in international financial reporting standards.

Several former executive members have been recruited as non-executives immediately after they retired from full-time service. A recent death, however, has reduced the number of non-executive directors to two. These sit alongside an executive board of seven that, apart from Mary, have all been in post for over ten years.

Mary noted that board meetings very rarely contain any significant discussion of strategy and never involve any debate or disagreement. When she asked why this was, she was told that the directors had all known each other for so long that they knew how each other thought. All of the other directors came from similar backgrounds, she was told, and had worked for the company for so long that they all knew what was 'best' for the company in any given situation. Mary observed that notes on strategy were not presented at board meetings and she asked Timothy Rosh whether the existing board was fully equipped to formulate strategy in the changing world of retailing. She did not receive a reply.

**Required:**

- (a) **Explain 'agency' in the context of corporate governance and criticise the governance arrangements of Rosh and Company.** (12 marks)
- (b) **Explain the roles of a nominations committee and assess the potential usefulness of a nominations committee to the board of Rosh and Company.** (8 marks)
- (c) **Define 'retirement by rotation' and explain its importance in the context of Rosh and Company.** (5 marks)

**(25 marks)**

- 4 At an academic conference, a debate took place on the implementation of corporate governance practices in developing countries. Professor James West from North America argued that one of the key needs for developing countries was to implement rigorous systems of corporate governance to underpin investor confidence in businesses in those countries. If they did not, he warned, there would be no lasting economic growth as potential foreign inward investors would be discouraged from investing.

In reply, Professor Amy Leroi, herself from a developing country, reported that many developing countries are discussing these issues at governmental level. One issue, she said, was about whether to adopt a rules-based or a principles-based approach. She pointed to evidence highlighting a reduced number of small and medium sized initial public offerings in New York compared to significant growth in London. She suggested that this change could be attributed to the costs of complying with Sarbanes-Oxley in the United States and that over-regulation would be the last thing that a developing country would need. She concluded that a principles-based approach, such as in the United Kingdom, was preferable for developing countries.

Professor Leroi drew attention to an important section of the Sarbanes-Oxley Act to illustrate her point. The key requirement of that section was to externally report on – and have attested (verified) – internal controls. This was, she argued, far too ambitious for small and medium companies that tended to dominate the economies of developing countries.

Professor West countered by saying that whilst Sarbanes-Oxley may have had some problems, it remained the case that it regulated corporate governance in the 'largest and most successful economy in the world'. He said that rules will sometimes be hard to follow but that is no reason to abandon them in favour of what he referred to as 'softer' approaches.

- (a) There are arguments for both rules and principles-based approaches to corporate governance.

**Required:**

- (i) Describe the essential features of a rules-based approach to corporate governance; (3 marks)
- (ii) Construct the argument against Professor West's opinion, and in favour of Professor Leroi's opinion that a principles-based approach would be preferable in developing countries. Your answer should consider the particular situations of developing countries. (10 marks)

- (b) The Sarbanes-Oxley Act contains provisions for the attestation (verification) and reporting to shareholders of internal controls over financial reporting.

**Required:**

Describe the typical contents of an external report on internal controls. (8 marks)

- (c) Construct the arguments in favour of Professor Leroi's remark that external reporting requirements on internal controls were 'too ambitious' for small and medium companies. (4 marks)

**(25 marks)**

**End of Question Paper**