
Answers

1 (a) *Distinguish and identify*

Voluntary stakeholders are those that engage with an organisation of their own choice and free will. They are ultimately (in the long term) able to detach and discontinue their stakeholding if they choose. Involuntary stakeholders have their stakeholding imposed and are unable to detach or withdraw of their own volition.

The voluntary stakeholders identified in the case are: Forward Together (the trade union), Heskett Nuclear employees, the Ayland government, the board of HPC, local authorities, No Nuclear Now and other nuclear producers who use the reprocessing facility.

The involuntary stakeholders – those whose stakeholding is placed upon them by virtue of their physical position – are the governments of Beeland and Ceeland, the local community and the seal colony.

[Tutorial note: membership of these categories is contestable if time perspectives are introduced. In the short term, some voluntary stakeholders are involuntary in that their involvement cannot be quickly withdrawn. The case clearly identifies the involuntary stakeholders.]

Assess the claims

The case identifies three 'affected' stakeholders that are clearly involuntary. Both Beeland and Ceeland say that they are stakeholders because of their geographical position and the seals are unable to move because of local environmental conditions.

Beeland government's claim is based on its position near to the Heskett plant. With the capital 70 km from the plant, it claims that it is already the 'victim' of low level radiation in the sea between the two countries. The case does not give the radius of damage if a major incident were to occur but it does say that there is 'scientific support' for the view that it could affect the capital of Beeland. Assuming that both of these statements are accurate then the Beeland government would appear to have a legitimate and reasonable claim that they are affected by the Heskett Nuclear plant and could be further affected in the future.

The government of Ceeland claims to be a potential 'victim' of nuclear contamination from the HN plant and has sought to have the plant closed as a result. The weakness of its claim rests upon the physical distance away from HN (500 km). If the threats to Ceeland are, as scientists have suggested, 'unfounded and borne of ignorance' then clearly Ceeland has a weak claim over Heskett Nuclear. It may have political reasons of its own to make protestations, perhaps to appease opinion in Ceeland or to be populist to manage dissent at home.

The case says that the local seal colony is unable to move away from the HN plant because of the local environmental conditions there and so it is unable to discontinue its stakeholding. It is thus involuntary. Low level emissions could potentially affect the seals and their food sources and any major incident would obviously impact it significantly. Whilst their affectedness is therefore indisputable, the value of the colony's claim rests in part upon the value placed upon sea life value against human and economic value. This assessment is therefore contestable.

The local community is another involuntary stakeholder albeit with a weaker involuntary element than the above three described. Whilst not structurally involuntary (they are able to move away if they do not like it), many local citizens may have lived near the HN plant for many years before it was built and may therefore have simply had to accept its development regardless of their views. The impacts on local communities can be positive or negative in that HN supports them through the provision of jobs but they would also be the first and most affected if there ever was a major incident at the HN plant.

[Tutorial note: allow for other 'affected' stakeholders if coherently argued. It is possible to argue that the taxpayers of Ayland are affected involuntary stakeholders, for example.]

(b) *Roles of employee representatives*

Trade unions are the most usual example of employee representation in corporate governance. Trade unions represent employees in a work facility such as an office or a plant. Membership is voluntary and the influence of the union is usually proportional to its proportion of membership.

Although a trade union is by default assumed to have an adversarial role with management, its ability to 'deliver' the compliance of a workforce can help significantly in corporate governance. When an external threat is faced, such as with the reputation losses following the 1970s leak, then the coalition of workforce (via Forward Together) and management meant that it was more difficult for external critics to gain support.

A trade union is an actor in the checks and balances of power within a corporate governance structure. Where management abuses occur, it is often the trade union that is the first and most effective reaction against it and this can often work to the advantage of shareholders or other owners, especially when the abuse has the ability to affect productivity.

Trade unions help to maintain and control one of the most valuable assets in an organisation (employees). Where a helpful and mutually constructive relationship is cultivated between union and employer then an optimally efficient industrial relations climate exists, thus reinforcing the productivity of human resources in the organisation. In defending members' interests and negotiating terms and conditions, the union helps to ensure that the workforce is content and able to work with maximum efficiency and effectiveness.

Critically evaluate the contribution of Forward Together from HPC's perspective

Helpful roles

The case describes Forward Together's (FT) role as *generally supportive of the development of the Heskett Nuclear site*. Clearly, with a primary loyalty to its members, FT will always pursue causes that are going to maximise members' job security. When the primary external stakeholder pressure is for the reduction of the HN site, the *union and board are aligned in their objectives* for the continuation of the facility.

FT's statement over *Ceeland's concern was very helpful to the HPC board*. FT has a clear interest in diffusing unfounded concern where it exists and its statement that Ceeland's fears were 'entirely groundless' would reinforce the power of any similar such statement made by others. Similarly, FT provided support after the leakage incident in the 1970s. The helpful reinforcement was evident when *FT pointed to the impeccable safety record and compliance*. This may have meant more as a public relations exercise coming from the trade union rather than the HPC board as FT is independent of the company.

Unhelpful roles

FT's wage pressure, over time, put a *pressure on the company's costs* that had, according to the HPC board, created the need to bring in cheaper foreign workers to fulfil the maintenance contract. From the board of HPC's viewpoint, such pressure was *ultimately self-defeating* for the union and effectively meant that the previous maintenance contractor was priced out. The union had been short-sighted in its year-on-year wage demands.

We are not told whether the board agrees with Kate Allujah that workers from Ayland were 'more reliable' in such a risk sensitive industry, but her comment was possibly based on prejudice against foreign workers entering the country. She seemed to be *unconcerned with the legal implications* of her outrage. Given that the company was legally entitled to employ foreign workers in Ayland, she had no valid legal argument for her position. From an economic perspective, it is also unhelpful, from HPC's perspective to have the union making high wage demands and then complaining about legitimate measures that the company takes to stay within its government subsidy such as cutting costs, including labour costs.

Conclusion

HPC's relationship with FT has been *positive and mutually beneficial* for the majority of the company's history. Clearly seeing their destinies to be linked, *FT has supported the company against external threats but has, at the same time, used its good relations to make wage demands* that ultimately led to the award of a maintenance contract to the foreign workers. This would have broken an important relationship with experienced maintenance personnel and the foreign workers may or may not have had the same level of expertise as the previous workers.

(c) *Explain agency relationship*

An agency relationship is one of trust between an *agent and a principal* which obliges the agent to *meet the objectives placed upon it by the principal*. As one appointed by a principal to manage, oversee or further the principal's specific interests, the primary purpose of agency is to discharge its fiduciary duty to the principal. In this case, there is an agency relationship between the government and the board of HPC.

Examine existing agency relationship

Although HPC is run by a conventional board, the *company is wholly owned by the government of Ayland*. This means that the company's *strategic objectives are determined by the government* and these are likely to be *different from purely commercial concerns*. The nuclear operation is clearly not economic in terms of profit and so the government's objectives for the company must be other than that. The case describes this in terms of broadening its energy portfolio and meeting environmental objectives. The board's objectives are likely to be predominantly financial, due to the control by subsidy placed upon it, but the principal's political and environmental concerns may also affect the objectives placed upon the HPC board (such as employment objectives in what is a deprived region of Ayland).

The principal is the government of Ayland and ultimately the board is accountable to the taxpayers of Ayland. This means that the development and even the existence of HN is ultimately under democratic control. The agency relationship means that the board of HPC has subsidy targets and also sees its role as fulfilling an important role in Ayland's energy portfolio.

HPC as a 'conventional' company owned by private shareholders

If HPC was a private company, its *principals would be shareholders with very different objectives*. Shareholders would be *predominantly concerned with the economic performance* of HP and the economies of the nuclear power industry. It would insist that the board pursued *only those parts of the business that were profitable*. This would necessitate a radical redesign of HPC's business as we are told that in its present form it is loss-making.

(d) (i)

Statement

Heskett Power Company's response to the report produced by NNN

Importance of risk assessment at Heskett Power Company

Heskett Power Company was recently dismayed to have been made aware of a report conducted by an anti-nuclear pressure group purporting to be a risk assessment of selected risks to the Heskett Nuclear plant. The company would like to take this opportunity to inform the public about the irresponsibility of the pressure group's activity whilst comprehensively rejecting its arguments.

In all industries it is important to assess risks as accurately as possible but in the nuclear power industry, it is critical. It is because the pressure group misrepresented our risks that we feel it necessary to remind stakeholders about the importance of a correct risk assessment based on valid measurements.

In observing best practice, Heskett Nuclear carries out thorough and continual risk assessments in compliance with our regulatory frameworks. The information going into the process must be as accurate as possible because *resources are allocated in part on the basis of our risk assessments*. Clearly, a risk assessed as probable and of high impact would attract a significant resource allocation and to have incorrect information could conceivably lead to the misallocation of company resources. This, in turn, would be a failure of our duty to the HPC company and ultimately to our owners, the government of Ayland and its taxpayers. The fact that there has not been a serious incident since the 1970s highlights the efforts that we take with risk assessment.

The ways in which we manage risk also depend upon the assessment. Once a risk, such as the risk of a nuclear leakage, is identified and assessed, the company pursues a strategy for managing that risk, typically to transfer or share the risk, avoid the risk, reduce it or accept it. This has implications for the entire strategy of the organisation, especially where the assessed risks are strategic in nature. Inaccurate assessment might, for example, mean accepting a risk that should have been avoided or *vice versa*.

Our stakeholders expect us to be a responsible company in all matters but especially in matters of safety and the environment. *We owe it to our local community, employees and others to ensure that all risks are fully but accurately understood*. In addition to ensuring that we are fully compliant with all regulatory regimes applicable to us, we believe that accurate risk assessment is necessary to our valued reputation as an ethical and responsible employer and neighbour.

Finally, as we have seen in the case of this misguided report by the pressure group, *inaccurate assessments can breed fear, distrust and unnecessary panic*. HPC was disappointed to hear the report being used by critics when the information it contained was inaccurate and this leads us to the second matter.

(ii) *HN's social and environmental 'footprint'*

HPC is aware of some critics that have asserted that our overall footprint is negative. In responding to this, we feel it necessary to remind readers that the footprint of any organisation includes the *sum total of its positive and negative interactions* with the environment. Whilst this sometimes involves negative impacts such as carbon emissions and accidental pollution, it also takes into account the positive impacts such as social benefit, through such things as job creation, and positive environmental impacts. *Both 'sides' need to be taken into account* before an overall evaluation of the social and environmental footprint can be established. To focus on only a small number of measures, as some of our critics have done, is to provide an unfair and biased account of our genuine overall footprint.

Social arguments

It is our belief that Heskett Nuclear makes a substantial positive contribution on both social and environmental measures. In terms of social contribution, HN makes a positive impact for several reasons. Whilst accepting that Heskett Nuclear has its critics, the company would like to remind the public both in Ayland and Beeland that the plant is a very large employer and *vital to the economic well-being of the region*, a fact recognised by a wide range of local and national stakeholders. Others have noted the importance of the jobs provided at Heskett Nuclear to the social and economic well-being of the region and HPC fully agrees with this analysis.

In addition to the jobs provided in Ayland, Heskett Nuclear also provides reprocessed fuel that is cheaper than virgin fuel. This provides support for *nuclear power, and hence clean energy, in several developing countries* that are our valued customers. Heskett Nuclear therefore indirectly *supports employment and social development in those countries*. Were our reprocessed fuel unavailable to them, rates of economic and social development growth may be slowed in those countries. We are therefore determined to continue to supply this vital input into those countries and to continue to support them.

Environmental arguments

In addition, as a non-fossil fuel industry, nuclear is *relatively non-polluting and is an essential component of the government of Ayland's clean energy strategy*. Heskett Nuclear is proud to be a part of that strategy and will continue to be a dependable producer of nuclear power and reprocessing services. In so doing we will continue to carefully manage the risks of nuclear power supply whilst providing the jobs and clean energy for which Heskett Nuclear is corporately responsible. A likely alternative to nuclear is the burning of more polluting fossil fuels which would presumably be as unacceptable to our critics as it is to us.

Whilst conceding that all nuclear operations require a high level of safety and regulatory observance, we are pleased to be able to remind our stakeholders, including the governments of Beeland and Ceeland, of our *very high performance in this area*. As our colleagues in the Forward Together trade union recently said, Heskett Nuclear has had an impeccable safety record since the 1970s and is fully compliant with all relevant safety regulations. We fully intend to maintain this high level of performance.

[Tutorial note: allow latitude in responding to part (ii), especially rewarding answers referring to the specific case of nuclear]

2 (a) *Criticisms of remuneration committee*

The remuneration committee has demonstrated failures of duty in several areas.

There is evidence of a *lack of independence in the roles of the non-executive directors* (NEDs) who comprise the committee. One of the main purposes of NEDs is to bring independent perspectives within the committee structure and shareholders have the right to expect NEDs to not be influenced by executive pressure in decision-making (such as from the finance directors). Two of the NEDs on the remuneration committee were former colleagues of Mr Woof, creating a further conflict. The effect of this lack of independence was a factor in the creation of Mr Woof's unbalanced package. That, in turn, increased agency costs and made the agency problem worse.

There was a clear breach of good practice with the remuneration committee *receiving and acting on the letter from Mr Woof* and agreeing to the design of the remuneration package in such a hasty manner. Remuneration committees should not receive input from the executive structure and certainly not from directors or prospective directors lobbying for their own rewards. Mr Woof was presumptuous and arrogant in sending the letter but the committee was naive and irresponsible in receiving and acting upon it.

There is evidence that the remuneration was *influenced by the hype* surrounding the supposed favourable appointment in gaining the services of Mr Woof. In this regard it lacked objectivity. Whilst it was the remuneration committee's role to agree an attractive package that reflected Mr Woof's market value, the committee was seemingly *coerced by the finance director and others* and this is an abdication of their non-executive responsibility.

The committee *failed to build in adequate performance related components* into Mr Woof's package. Such was the euphoria in appointing Mr Woof that they were influenced by a clearly excitable finance director who was so keen to get Mr Woof's signature that he counselled against exercising proper judgement in this balance of benefits. Not only should the remuneration committee have not allowed representations from the FD, it should also have given a great deal more thought to the balance of benefits so that bonuses were better aligned to shareholder interests.

The committee *failed to make adequate pension and resignation arrangements* that represented value for the shareholders of Tomato Bank as well as for Mr Woof. Whilst pension arrangements are within the remit of the remuneration committee and a matter for consideration upon the appointment of a new chief executive, shareholder value would be better served if it was linked to the time served in the company and also if the overall contribution could be reconsidered were the CEO to be removed by shareholders for failure such as was the case at Tomato Bank.

[Tutorial note: candidates may express these and similar points in several ways]

(b) *Components of a rewards package*

The components of a typical executive reward package include *basic salary*, which is paid regardless of performance; *short and long-term bonuses* and incentive plans which are payable based on pre-agreed performance targets being met; *share schemes*, which may be linked to other bonus schemes and provide options to the executive to purchase predetermined numbers of shares at a given favourable price; *pension and termination benefits* including a pre-agreed pension value after an agreed number of years' service and any 'golden parachute' benefits when leaving; plus any number of other *benefits in kind* such as cars, health insurance, use of company property, etc.

Balanced package is needed for the following reasons

The overall purpose of a well-designed rewards package is to achieve a *reduction (minimisation) of agency costs*. These are the costs the principals incur in monitoring the actions of agents acting on their behalf. The main way of doing this is to ensure that executive reward packages are *aligned with the interests of principals* (shareholders) so that directors are rewarded for meeting targets that further the interests of shareholders. A reward package that only rewards accomplishments in line with shareholder value substantially decreases agency costs and when a shareholder might own shares in many companies, *such a 'self-policing' agency mechanism is clearly of benefit*. Typically, such reward packages involve a bonus element based on specific financial targets in line with enhanced company (and hence shareholder) value.

Although Mr Woof came to Tomato Bank with a very good track record, *past performance is no guarantee of future success*. Accordingly, Mr Woof's reward package should have been subject to the same detailed design as with any other executive package. In hindsight, a pension value linked to performance and sensitive to the manner of leaving would have been a worthwhile matter for discussion and also the split between basic and incentive components. Although ambitious to design, it would have been helpful if the reward package could have been made reviewable by the remuneration committee so that a *discount for risk could be introduced* if, for example, the internal audit function were to signal a high level of exposure to an unreliable source of funding. As it stands, the worst that can happen to him is that he survives just two years in office, during which time he need not worry about the effects of excessive risk on the future of the company, as he has a generous pension to receive thereafter.

(c) *Ethical case for repaying part of pension*

Mr Woof was the *beneficiary of a poor appointments process* and his benefits package was designed *in haste and with some incompetence*. He *traded freely on his reputation* as a good banker and probably inflated his market value as a result. He then *clearly failed in his role* as a responsible steward of shareholders' investments and in his fiduciary duty to investors. In exposing the bank to financing risks that ultimately created issues with the bank's economic stability, it was *his strategies that were to blame* for the crisis created. The fact that he is receiving such a generous pension is *because of his own lobbying* and his *own assurance of good performance* places an obligation on him to accept responsibility for the approach he made to the remuneration committee five years earlier.

The debate is partly about legal entitlement and ethical responsibility. Although he is legally entitled to the full value of the pension, it is the perception of what is fair and reasonable that is at stake. It is evident that Mr Woof is being self-serving in his dealings and in this regard is operating at a *low level of Kohlberg's moral development* (probably level 1 in seeking maximum rewards and in considering only the statutory entitlement to these in his deliberations). A more developed sense of moral reasoning would enable him to see the wider range of issues and to act in conformity with a higher sense of fairness and justice, more akin to behaviour at Kohlberg's level 3.

[Tutorial note: it is possible to express this case in a range of ways]

3 (a) Distinguish between rules and principles

This case refers to compliance with regard to internal control systems in particular but rules and principles are the two generic approaches to corporate governance and depend upon the nature of regulation. *Rules-based control is when behaviour is underpinned and prescribed by statute* of the country's legislature. Compliance is therefore enforceable in law such that companies can face legal action if they fail to comply.

In a principles-based jurisdiction, *compliance is required under stockmarket listing rules but non-compliance is allowed based on the premise of full disclosure* of all areas of non-compliance. It is believed that the market mechanism is then capable of valuing the extent of non-compliance and signalling to the company when an unacceptable level of compliance is reached.

Benefits to an organisation

There are four main benefits to the organisation of a principles-based approach. First, it *avoids the need for strict compliance with inflexible legislation* which, typically, fails to account for differences in size and the risk profiles of specific companies or sectors. This means (second) that compliance is *less burdensome in time and expenditure* for the organisation as the minutiae of general legislation can be interpreted in context rather than obeyed in detail. Third, a principles-based approach allows companies to *develop their own sector and situation-specific approaches* to internal control challenges. These will typically depend upon each company's interpretation of its own internal control challenges. For example, physical controls over cash will be vital to some businesses and less relevant or not applicable to others. Fourthly, this, in turn, allows for *flexibility and temporary periods of non-compliance* with relevant external standards on the basis of 'comply or explain', a flexibility that would not be possible in a rules-based jurisdiction.

(b) Non-industry specific (i.e. general) advantages of internal controls

The advantages and benefits of internal controls are partly as described in COSO's reasons. The case describes these benefits in terms of enjoying *'greater internal productivity and producing higher quality reporting'*. In addition, internal control *underpins investor confidence, ensures compliance* with internal and external control measures and facilitates the *provision of management reports* as needed.

Mr Rogalski is incorrect in his view that controls need to be industry sector specific to be effective. The *effective and efficient performance of businesses* of all kinds rest upon the observance of well-designed and tightly-monitored internal controls. Waste in the form of lost time, wasted resources, faults and other costs are avoided. Efficiency is increased by conformance to standards designed to support productivity. However, the types of controls in place and the systems supporting them will differ from sector to sector.

The information gained from compliance with internal control measures is used in the preparation of *content for internal and external reporting*. This is especially applicable to the external reporting on internal controls such as under Sarbanes Oxley s.404 which is mandatory in the USA. Other national codes have similar provisions.

Where *compliance with agreed standards* is an important part of the business, internal control data allows for this. This can be industry sector-specific but the general principles of effective control apply to all types of organisations: internal control data is needed to demonstrate compliance. Examples of sector specific internal controls (for managing sector-specific risks) include measures in financial services or those complying with certain ISO standards in their products or processes (e.g. ISO 14000).

Internal controls *underpin and cultivate shareholder confidence* which is relevant in any industry setting. Acceptable returns on shares rest upon conformity with systems to ensure adequate levels of efficiency, effectiveness, security, etc and the avoidance of waste and fraud.

Internal control systems enable the *provision of reports and other information* as needed by either external agencies or internal management. Whilst some industries are likely to have a need for external reporting (e.g. nuclear, oil and gas), internal report provision is necessary in any industry.

[Tutorial note: allow for other relevant points in answers. Some candidates may bring relevant content in from earlier auditing paper]

'Unmonitored controls tend to deteriorate over time'

This statement refers to the need to establish which controls need to be monitored to support a sound system of internal controls and how to monitor those controls. Once a control system is designed and responsibilities for its management allocated, only those targets and controls that are made a part of someone's job or performance measurement will be monitored and thereby maintained. Any metrics that are not a part of this control regime will go unchecked and may not remain within compliance limits as circumstances change over time. The main roles of internal audit are to provide information to management on the relevance and effectiveness of internal control systems and to provide the evidence to demonstrate why those controls are effective or not. This requires the identification of which controls to monitor and developing effective ways of monitoring those controls.

The complexity of the control regime is also relevant. There is a balance between having a sufficient number of controls in place and having too many. In this context, 'too many' means that control systems must be actually useable. Over-complex controls are likely to deteriorate over time if their monitoring is not possible within reasonable cost limits and this could also cause operational inefficiencies.

Furthermore, an organisation is not static and so different controls will be needed over time. As activities change as a result of changes in organisational strategy, the controls that need to be monitored change and the tolerances of those controls may also change (they may become tighter or looser). Constant updating of controls is therefore necessary, especially in frequently changing business environments.

(c) *Internal audit testing*

This is the *internal assessment of internal controls* using an internal auditor or internal audit function applying audit techniques to controls based on predetermined measures and outcomes. It is a management control over the other internal controls in an organisation and *ensures the levels of compliance and conformity* of the internal controls in an organisation.

Role of internal audit in ensuring effective internal controls

Internal audit underpins the effectiveness of internal controls by performing several key tasks.

Internal audit *reviews and reports upon the controls* put in place for the key risks that the company faces in its operations. This will involve ensuring that the control (i.e. mitigation measure) is capable of controlling the risk should it materialise. This is the traditional view of internal audit. A key part of this role is to review the design and effectiveness of internal controls. Many organisations also require internal audit staff to conduct follow-up visits to ensure that any weaknesses or failures have been addressed since their report was first submitted. This ensures that staff take the visit seriously and must implement the findings.

Internal audit may also involve an *examination of financial and operating information* to ensure its accuracy, timeliness and adequacy. In the production of internal management reports, for example, internal audit may be involved in ensuring that the information in the report is correctly measured and accurate. Internal audit needs to be aware of the implications of providing incomplete or partial information for decision-making.

It will typically *undertake reviews of operations for compliance against standards*. Standard performance measures will have an allowed variance or tolerance and internal audit will measure actual performance against this standard. Internal compliance is essential in all internal control systems. Examples might include safety performance, cost performance or the measurement of a key environmental emission against a target amount (which would then be used as part of a key internal environmental control).

Internal audit is used to review internal systems and controls for compliance with relevant regulations and externally-imposed targets. Often assumed to be of more importance in rules-based jurisdictions such as the United States, many industries have upper and lower limits on key indicators and it is the role of internal audit to measure against these and report as necessary. In financial services, banking, oil and gas, etc, legal compliance targets are often placed on companies and compliance data is required periodically by governments.

[Tutorial note: allow latitude when candidates introduce content from earlier papers, particularly F8, *Audit and Assurance*]

4 (a) *Difference*

A family or insider-dominated business is one in which the *controlling shareholding is held by a small number of dominant individuals*. In many cases, these individuals will also work for the business making them owner-managers. When the insiders belong to a nuclear or extended family it is common to refer to the business as a family firm. In a listed company, *the shares are dispersed between many shareholders, the shares are publicly traded* and managers are unlikely to be substantial shareholders themselves (although they may own shares as a part of their reward packages).

Explore the governance issues

The *agency issues* are quite different in the two types of business. There are usually lower agency costs associated with insider-dominated businesses owing to there being fewer agency trust issues. Less monitoring is usually necessary because the owners are often also the managers. Principals (majority shareholders) are able to directly impose own values and principles (business or ethical) directly on the business without the mediating effect of a board. In the case of 'Healthy and happy', Ken and Steffi have been the majority owners for all of its 40 years and as long as they trust each other, director monitoring costs should be very low. This is complicated by the new knowledge that there are trustworthiness questions over Ivan.

Short and long-term decision-making issues and the pursuit of motives other than short-term profits. A smaller base of shareholders are more likely to be flexible over when profits are realised and so the expectations of the rates and timings of returns are likely to be longer. This gives management more strategic flexibility especially if, as is the case at 'Happy and healthy' the purpose of the business is simply to leave it in a good state to pass on to Ivan when Ken and Steffi retire. Ken and Steffi are motivated by factors other than the pursuit of short-term profit, such as promotion of healthy food, good service to customers, etc.

'*Gene pool*' and *succession issues* are common issues in family businesses. It is common for a business to be started off by a committed and talented entrepreneur but then to hand it on to progeny who are less equipped or less willing to develop the business as the founder did. When the insiders are unwilling or unable to buy in outside management talent then this issue is highlighted. There are clearly doubts over Ivan's commitment to the business if he has started up a competing business with his wife and this may mean an unfortunate outcome for 'Happy and healthy'. In addition, there are important differences in the

formality of nominations, appointments and rewards. In larger companies these matters are dealt with by a formal committee structure whereas they are likely to be more informal in family businesses.

'Feuds' and conflict resolution can be major governance issues in an insider-dominated business. Whereas a larger bureaucratic business is capable of 'professionalising' conflict (including staff departures and disciplinary actions) this is less likely to be the case in insider-dominated businesses. Family relationships can suffer and this can intensify stress and ultimately lead to the deterioration of family relationships as well as business performance. Ivan's actions are likely to be relevant here as his transfer of inventory to Barong Company is likely to place a severe strain on the Potter family relationships.

[Tutorial note: allow for a range of relevant responses in the exploration]

(b) Accountants as professionals

Society accords professional status to those that both possess a high level of technical knowledge in a given area of expertise (accounting, engineering, law, dentistry, medicine) on the understanding that the expertise is used in the public interest. The body of knowledge is gained through passing examinations and gaining practical expertise over time. Acting in the public interest means that the professional always seeks to uphold the interests of society and the best interests of clients (subject to legal and ethical compliance).

Fundamental principles (responsibilities) as a professional

Society has reasonable expectations of all professionals. The major professional responsibilities of any professional are as follows:

Integrity. The highest levels of probity in all personal and professional dealings. Professionals should be straightforward and honest in all relationships. This has clear implications for Mr Shreeves in his dealings with Ken and Steffi.

Objectivity. Professionals should not allow bias, conflicts of interest or undue influence to cloud their judgements or professional decisions. In this case, Mr Shreeves should not allow his friendship with the Potters to affect his judgement as an auditor.

Professional competence and due care. Professionals have a duty to ensure that their skills and competences are continually being updated and developed to enable them to serve clients and the public interest. This includes continuing to study and scrutinise ethical guidance from Mr Shreeves's own professional accounting body and also IFAC.

Confidentiality. Professionals should, within normal legal constraints, respect the confidentiality of any information gained as a result of professional activity or entrusted to them by a client.

Professional behaviour. Professionals should comply fully with all relevant laws and regulations whilst at the same time avoiding anything that might discredit the profession or bring it into disrepute.

- (c)** The normal behaviour for the auditor, regardless of the options available in this situation, would be to initially seek representations from Ivan to establish whether there is an explanation that has so far been overlooked or not known about. Following that, there are two options in Mr Shreeves's dilemma: to tell or not tell Ken and Steffi about Ivan's behaviour. In discussing these options, a number of issues are relevant.

Discussion of dilemma

Mr Shreeves is clearly in a difficult situation but he must be aware of *his duty as a professional accountant* which includes, in his role as auditor, a duty to the public interest. He has a *duty of due care and diligence* to society and government as well as the shareholders of a company being audited. Being complicit in Ivan's activity is clearly not an option as this would be incompatible with his duties to the shareholders and to society in his role as auditor. Furthermore, he has realised a disclosure of such transactions is required and it would be unprofessional not to discuss this with his clients.

He *feels he owes a debt to the Potter family as a longstanding family friend* and this has the potential to cloud his judgement as the company's auditor. The case says that the effect of Ken and Steffi finding out about Ivan's theft could be 'devastating' and this is bound to weigh heavily upon Mr Shreeves's mind. In getting too close to the family, Mr Shreeves has compromised his duty as auditor as he is probably less objective than he should be. He should probably have chosen between being a family friend or being the auditor some years ago and that would have made his resolution of the dilemma somewhat easier.

Ivan has been *unprofessional and has acted fraudulently* in his dealings with 'Happy and healthy'. In such a situation, the auditor does not have latitude in how he or she deals with such a discovery. It is a very serious breach of trust by Ivan, regardless of whether he is the Potters' son or not, and it would be inexcusable to withhold this information from the owner-managers of the business.

Advise Mr Shreeves

Given that the auditor has a duty to the public interest and the company shareholders, he should *inform the majority shareholders (Ken and Steffi) what he has found during the audit*. To do anything other than this would be to act unprofessionally and irresponsibly towards the majority shareholders of the company. Family relationships or friendships must never be allowed to interfere with an auditor's professional duty and independence. This approach need not be in the form of a blunt confrontation, however, and it would *not be unprofessional to speak with Ivan before he spoke to his parents in order to convey to him the potential seriousness of his actions*.

- 1 (a)** 2 marks for distinguishing between the two types of stakeholders
1/2 mark for each voluntary stakeholder identified up to a maximum of 2
1/2 mark for each involuntary stakeholder identified up to a maximum of 2
2 marks for each assessment of the three involuntary stakeholders (which may include explanation of why they are involuntary) (12 marks)
- (b)** 2 marks for each relevant role identified and explained up to a maximum of 6 marks
Critical evaluation
2 marks for each helpful/positive role identified and discussed
2 marks for each unhelpful/negative role identified and discussed
2 marks for conclusion/summary (Maximum 10 marks)
- (c)** 1 mark for each relevant point on explaining agency relationship to a maximum of 2
1 mark for each relevant point in the exploration of HPC's agency with the government of Ayland to a maximum of 6
1 mark for each relevant point on HPC as a 'conventional' company to a maximum of 2 (10 marks)
- (d) (i)** 1 mark for each relevant point identified and 1 for explanation in the context of the case (8 marks)
- (ii)** 2 marks for evidence of understanding of 'footprint' in context
1 mark for each relevant positive social and environmental impact convincingly argued for, to a maximum of 4 marks (6 marks)
- Professional marks (4 marks)
- 2 (a)** 2 marks for each criticism identified and discussed (10 marks)
- (b)** 1 mark for each component identified and described (1/2 mark for identification only) to a maximum of 5 marks
1 mark for each relevant point of explanation of the benefits of a balanced package for Mr Woof to a maximum of 5 (10 marks)
- (c)** 1 mark for each relevant point made (5 marks)
- 3 (a)** 3 marks for distinguishing between rules and principles
1 mark for each relevant advantage/benefit of principles-based to a maximum of 4 (7 marks)
- (b)** 1 mark for recognition of each advantage and 1 for development of that point to a maximum of 8 marks
2 marks per point for explanation of the statement up to a maximum of 4 marks (Maximum 10 marks)
- (c)** 2 marks for definition of internal audit testing
2 marks for each internal role identified and explained to a maximum of 8 (Maximum 8 marks)
- 4 (a)** 1 mark for each relevant point distinguishing between a family and listed business up to a maximum of 2 marks
2 marks for each relevant point of exploration identified and discussed up to a maximum of 8 marks (10 marks)
- (b)** 1 mark per relevant point explained on accountants as professionals up to a maximum of 2 marks
1 mark for each relevant fundamental principle of professionalism described up to a maximum of 5. Half mark for mention only (7 marks)
- (c)** 2 marks for each relevant issue in the dilemma identified and discussed up to a maximum of 6
1 mark for each relevant point made of the 'advise' point up to a maximum of 2 (8 marks)