

Professional Level – Essentials Module

Governance, Risk and Ethics

Wednesday 14 December 2011

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

P1 Paper

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

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

- 1 Coastal Oil is one of the world's largest petrochemical companies. It is based in Deeland and is responsible alone for 10% of Deeland's total stock market value. It employs 120,000 people in many countries and has an especially strong presence in Effland because of Effland's very large consumption of oil and gas products and its large oil reserves. Coastal Oil is organised, like most petrochemical companies, into three vertically integrated business units: the exploration and extraction division; the processing and refining division; and the distribution and retailing division.

Because of the risks and the capital investment demands, Coastal Oil has joint venture (JV) agreements in place for many of its extraction operations (i.e. its oil and gas rigs), especially those in the deep-water seas. A joint venture is a shared equity arrangement for a particular project where control is shared between the JV partners. In each of its JVs, Coastal Oil is the largest partner, although operations on each rig are divided between the JV member companies and the benefits are distributed according to the share of the JV.

As a highly visible company, Coastal Oil has long prided itself on its safety record and its ethical reputation. It believes both to be essential in supporting shareholder value. Its corporate code of ethics, published some years ago, pledges its commitment to the 'highest standards' of ethical performance in the following areas: full compliance with regulation in all jurisdictions; safety and care of employees; transparency and communication with stakeholders; social contribution; and environmental responsibility. In addition, Coastal Oil has usually provided a lot of voluntary disclosure in its annual report and on its website. It says that it has a wide range of stakeholders and so needs to provide a great deal of information.

One of the consequences of dividing up the different responsibilities and operations on an oil or gas rig is that Coastal Oil does not have direct influence over some important operational controls. The contractual arrangements on any given oil rig can be very complex and there have often been disagreements between JV partners on some individual legal agreements and responsibilities for health and safety controls. Given that Coastal Oil has JV interests in hundreds of deep-water oil and gas rigs all over the world, some observers have said that this could be a problem should an accident ever occur.

This issue was tragically highlighted when one of its deep-water rigs, the Effland Coastal Deep Rig, had an explosion earlier this year. It was caused by the failure of a valve at the 'well-head' on the sea floor. The valve was the responsibility of Well Services, a minor partner in the JV. Eight workers were killed on the rig from the high pressure released after the valve failure, and oil gushed into the sea from the well-head, a situation that should have been prevented had the valve been fully operational. It was soon established that Well Services' staff failed to inspect the valve before placing it at the well-head at the time of installation, as was required by the company's normal control systems. In addition, the valve was attached to a connecting part that did not meet the required technical specification for the water depth at which it was operating. The sea bed was 1,000 metres deep and the connecting part was intended for use to a depth of up to 300 metres. There was a suggestion that the need to keep costs down was a key reason for the use of the connecting part with the inferior specification.

Reports in the media on the following day said that the accident had happened on a rig 'belonging to Coastal Oil' when in fact, Coastal Oil was technically only a major partner in the joint venture. Furthermore, there was no mention that the accident had been caused by a part belonging to Well Services. A journalist did discover, however, that both companies had operated a more lax safety culture on the deep-water rigs than was the case at facilities on land (the 'land-side'). He said there was a culture of 'out of sight, out of mind' on some offshore facilities and that this meant that several other controls were inoperative in addition to the ones that led to the accident. Information systems reporting back to the 'land-side' were in place but it was the responsibility of management on each individual rig to enforce all internal controls and the 'land-side' would only be informed of a problem if it was judged to be 'an exceptional risk' by the rig's manager.

The accident triggered a large internal argument between Coastal Oil and Well Services about liability and this meant that there was no public statement from Coastal Oil for seven days while the arguments continued. Lawyers on both sides pointed out that liability was contractually ambiguous because the documentation on responsibilities was far too complex and unclear. And in any case, nobody expected anything to go wrong. In the absence of any official statement from Coastal Oil for those seven days, the media had no doubts who was to blame: Coastal Oil was strongly criticised in Effland with the criticism growing stronger as oil from the ruptured valve was shown spilling directly into the sea off the Effland coast. With no contingency plan for a deep-water well-head rupture in place, the ruptured valve took several months to repair, meaning that many thousands of tonnes of crude oil polluted the sea off Effland. Images of seabirds covered in crude oil were frequently broadcast on television and thousands of businesses on the coast

reported that the polluted water would disrupt their business over the vital tourist season. Public statements from Coastal Oil that it was not responsible for the ruptured valve were seemingly not believed by the Effland public. Senior legislators in Effland said that the accident happened on 'a rig belonging to Coastal Oil' so it must be Coastal Oil's fault.

A review by the Coastal Oil board highlighted several areas where risk management systems might be tightened to reduce the possibility of a similar accident happening again. Finance director, Tanya Tun, suggested that the company should disclose this new information to shareholders as it would be value-relevant to them. In particular, she said that a far more detailed voluntary statement on environmental risk would be material to the shareholders. The annual report would, she believed, be a suitable vehicle for this disclosure.

Because of the high media profile of the event, politicians from Effland involved themselves in the situation. Senator Jones's constituency on the coast nearest the rig was badly affected by the oil spill and many of his constituents suffered economic loss as a result. He angrily retorted in a newspaper interview that Coastal Oil's CEO, Susan Ahmed, 'should have known this was going to happen', such was the poor state of some of the internal controls on the Effland Coastal Deep Rig.

As the oil spill continued and the media interest in the events intensified, CEO Mrs Ahmed was summoned to appear before a special committee of the Effland national legislature 'to explain herself to the citizens of Effland'. The Coastal Oil board agreed that this would be a good opportunity for Mrs Ahmed to address a number of issues in detail and attempt to repair some of the company's damaged reputation. The board agreed that Mrs Ahmed should provide as full a statement as possible on the internal control failures to the special committee.

Required:

- (a) **Describe the general purposes of a corporate code of ethics and evaluate Coastal Oil's performance against its own stated ethical aims as set out in its code of ethics.** (10 marks)
- (b) **Explain, using examples, the difference between voluntary and mandatory disclosure, and assess Tanya Tun's proposition that additional voluntary disclosure on environmental risk management would be material to the shareholders.** (10 marks)
- (c) In preparing to appear before the special committee of the Effland national legislature, CEO Mrs Ahmed has been informed that she will be asked to explain the causes of the accident and to establish whether she can give assurances that an accident of this type will not re-occur.

Required:

Prepare a statement for Mrs Ahmed to present before the committee that explains the following:

- (i) **The internal control failures that gave rise to the accident;** (10 marks)
- (ii) **The difference between subjective and objective risk assessment (using examples). Argue against Senator Jones's view that Mrs Ahmed 'should have known this was going to happen';** (8 marks)
- (iii) **'Health and safety' risk and the factors that can increase this risk in an organisation;** (4 marks)
- (iv) **Why Coastal Oil cannot guarantee the prevention of further health and safety failures, using the ALARP (as low as reasonably practicable) principle;** (4 marks)

Professional marks will be awarded in part (c) for logical flow, persuasiveness, format and tone of the answers. (4 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

- 2 There has been a debate in the country of Geeland for some years about the most appropriate way to regulate corporate governance. Several years ago, there were a number of major corporate failures and ‘scandals’ caused in part by a number of single powerful individuals dominating their boards. Business leaders and policy-makers were sceptical about a rules-based approach, and this led the Geeland stock exchange to issue guidance in the ‘Geeland Code’ as follows:

‘Good corporate governance is not just a matter of prescribing particular corporate structures and complying with a number of rules. There is a need for broad principles. All stakeholders should then apply these flexibly to the varying circumstances of individual companies.’

Given the causes of the Geeland corporate governance failures, there was a debate about whether the separation of the roles of chairman and chief executive should be made a legal requirement. This resulted in the stock exchange issuing guidance that whilst a rules-based or ‘box ticking’ approach would specify that ‘the roles of chairman and chief executive officer should never be combined... We do not think that there are universally valid answers on such points.’

One company to take advantage of the flexibility in Geeland’s principles-based approach was Anson Company. In July 2010, Anson Company announced that it had combined its roles of chairman and chief executive in a single role carried out by one individual. In accordance with the Geeland listing rules, it made the following ‘comply or explain’ statement in its 2011 annual report:

‘Throughout the year the company complied with all Geeland Code provisions with the exception that from 1 July 2010 the roles of chairman and chief executive have been exercised by the same individual, William Klunker. We recognise that this has been out of line with best practice. We understand the concerns of shareholders but believe that we have maintained robust governance while at the same time benefiting from having Mr Klunker in control. On 31 July 2012 Mr Klunker will step down as executive chairman, remaining as chairman until we conclude our search for a non-executive chairman to succeed him, no later than March 2013.’

Required:

- (a) Briefly distinguish between rules and principles-based approaches to corporate governance. Critically evaluate the Geeland stock exchange’s guidance that ‘all stakeholders should then apply these flexibly to the varying circumstances of individual companies.’ (12 marks)
- (b) Explain why a separation of the roles of chairman and chief executive is considered best practice in most jurisdictions. (8 marks)
- (c) Assess the ‘comply or explain’ statement made by Anson Company in its 2011 annual report. (5 marks)

(25 marks)

3 After the government of Haichland decided to privatise its monopoly gas supplier (transferring it from government control to private ownership by issuing and selling shares), there was a period of transition as the new board took shape. A great deal of internal reorganisation and culture change was deemed necessary as the company moved to the private sector. The new company, called Dale Gas, set up a committee structure in readiness to comply with stock exchange listing rules. During this transitional period, some directors left and new ones, more familiar with operating in listed companies but unfamiliar with the gas industry, joined the board.

It was unanimously agreed by the new board that the previous chief executive, Helen Evans, should continue in her role after the privatisation. Tom Nwede, a fund manager at XY Investments, one of the company's major new institutional shareholders, said that the company would be exposed to higher market risk if she were to leave the company, so it was very important that she stayed on. She was seen as a highly competent CEO with excellent strategic and communication skills. She commanded the confidence and trust of the employees and also the new institutional investors.

One of the first actions of the new remuneration committee was to propose a doubling of Mrs Evans's salary. The committee said that she had been underpaid when the company was state-controlled because of government constraints on the salaries of public servants. The committee said that she now needed to receive a salary commensurate with the importance of the job and in line with other public listed companies of similar size. This proposal was widely publicised. Some criticised it on the basis that if her previous salary was considered sufficient then, why was it now felt necessary to double her rewards after privatisation?

Her new salary was put to the vote at the company's first annual general meeting after privatisation. Although many small shareholders (some protesting at the AGM itself) voted against her salary increase, it was easily passed by the proxy votes of the large institutional shareholders who did not attend the meeting in person. Tom Nwede, the XY Investments fund manager, said that the votes of the institutional shareholders were crucial in ensuring that Mrs Evans was retained, thereby mitigating market risk.

Required:

- (a) Explain the purposes of a chief executive's reward package and review the factors that might influence the level of reward for Mrs Evans after the privatisation. (10 marks)**
- (b) Define 'market risk' and justify, giving reasons, Tom Nwede's belief that retaining Mrs Evans was crucial in mitigating market risk. (10 marks)**
- (c) Define, and explain the advantages of, 'proxy voting' in the context of the case. (5 marks)**

(25 marks)

- 4 When Biggo Manufacturing (a public listed company) needed to build an extension to its factory, it obtained planning permission to build it on an adjacent field. The local government authority was keen to attract the new jobs that would go with the expansion and so granted the permission despite the objections of a number of residents, who were concerned that the new factory extension would mean the loss of a children's play area.

When the board of Biggo met after the building approval had been given, the chief executive read out a letter from Albert Doo, leader of the local government authority, saying that although permission to build had been given, the company should consider making a sizeable contribution towards creating a new children's play area in a nearby location. Mr Doo said that Biggo 'should recognise its social responsibility'. He said that the company should consider itself a citizen of society and should, accordingly, 'recognise its responsibilities as well as its legal rights'.

One of Biggo's directors, Robert Tens, said he thought the request was entirely reasonable given the displacement of the play area. He also said that they could use the donation strategically to help cultivate the company's reputation locally to help in future recruitment. It might also, he said, help to reduce resistance to any future expansion the company might need to make.

Margaret Heggs, in contrast, argued that the company should not make the donation as it was likely that company profits would be low in the current year. She said that the acquisition of the land and the gaining of planning permission were done through the normal legal channels and so the company had no further contractual or ethical duties to the local government, nor to the local community. She said that Biggo provided local employment and produced excellent products and so it was unreasonable for the request for a donation to have been made. 'This board is accountable to the shareholders of Biggo and not to the local community or the local government authority', she said.

Required:

- (a) Explain the meaning of 'rights' and 'responsibilities' in the context of Biggo and describe how these terms are interpreted at the two ends of the Gray, Owen & Adams 'continuum'. (10 marks)
- (b) Justify, using evidence from the case, which of Gray, Owen & Adams's positions are best described by the comments made by Robert Tens and also Margaret Heggs. (6 marks)
- (c) Define 'social responsibility' as used by Albert Doo. Contrast how short and long-term shareholder interest perspectives may affect Biggo's attitude to the requested contribution for the children's play area. (9 marks)

(25 marks)

End of Question Paper