London School of Business & Finance

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Paper P1

Governance, Risk & Ethics

Revision Mock Examination

December 2012

Question Paper

Time Allowed	15 minutes	Reading and planning
	3 hours	Writing

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.

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The question paper begins on page 4.

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

1 Reassurance, a company listed on its country's stock exchange, is a 235 year old insurance company based in Homeland. The company has been one of the top three in its industry for over 100 years and has been based in the same historic building throughout that time. Most of the big institutional investors in Homeland have held a stake in Reassurance for many years, and the company has always been seen as one of the safest long term investments available.

Last year the world's biggest insurance company, WIX, came close to collapse after a series of acquisitions went wrong. At around the same time, a worldwide recession added to their problems and they were forced to ask their government to save them. The government, fearing that the collapse of such a major company would cause a major lack of confidence, pumped several billion dollars into buying almost 80% of WIX's shares and took over the running of the company. Having decided that the company needed a total reorganisation and refinancing if it is to survive, they decided to look at selling off an overseas subsidiary called WIF, a major part of the WIX group based in Farawayland.

Three months ago the CEO of Reassurance, Bart Richards, told the board that they must prepare a bid to buy WIF. He noted that Farawayland is a rapidly growing economy in a high growth part of the world, and that Reassurance has virtually no corporate presence there. He also pointed out that such opportunities do not come up very often and that if Reassurance did not move quickly then one of their competitors would be sure to buy WIF instead. Other board members were not so sure of the merits of the deal. WIF would cost Reassurance several billion dollars, and the deal was unlikely to increase Reassurance profits for at least 3-5 years. The scale of the takeover would require a massive rights issue to shareholders, and the complex nature of the acquisition would require Reassurance to pay an estimated $400m in professional fees. Given the traditional history of Reassurance, shareholders would need a lot of persuasion before accepting the rights issue and some board members doubted they would ever vote in favour. However, the Chairman of Reassurance, Harvey Lewis, argued that the benefits of the takeover outweighed the costs and that he was backing his CEO's strategy. After an all-day board meeting, the directors narrowly voted in favour of the takeover, and they agreed that after the decision had been taken those opposed to the deal would show support so that the board could show a "united front" to shareholders and the outside world in general.

At first, negotiations on the takeover began in secret, with the boards of both Reassurance and WIX concerned that publicity could threaten the deal's success. However, after Bart Richards made repeated business trips to Farawayland, rumours in the Press began to circulate and the deal became public knowledge. Several leading shareholders in Reassurance immediately came out against the deal, despite Bart Richards and Harvey Lewis holding a series of private investor meetings to try to raise support. One major shareholder opposed to the deal, Saturn Pension Fund, started a protest group and attracted 23% of shareholders within a week. The board of Reassurance met last week and decided that it had no choice but to give up on the takeover proposal, as they were guaranteed to lose a forthcoming shareholder vote on the rights issue. A stock exchange announcement shortly after the board meeting confirmed that the deal was being abandoned.

Several shareholders have issued very critical press statements within the past few days, stating their amazement that the board ever considered the deal in the first place given the risks involved. One, Seven Investments, has questioned the competence of the board and asked for an analysis of the risks involved in the deal, to prove that the directors had thought it through properly in the first place. Some have said that the CEO was wholly responsible for the takeover strategy and would have to resign within days. Others insisted that the chairman should be held accountable for the board's failure to understand shareholder views, and for not putting a stop to the strategy at a far earlier stage. A small number of institutional shareholders have arranged to meet with the Senior Independent Director (in Singapore Lead Independent Director) of Reassurance to discuss their concerns. The Press have begun to speculate on who will be forced to leave the Reassurance board, with business journalists split between whether any new CEO (if a replacement becomes necessary) should come from the current board, or be an external candidate.

Required:

(a) **Explain the roles of the Chairman and the Senior Independent Director (SID) – in Singapore Lead Independent Director (LID) – in achieving good corporate governance, referring to the case as necessary.** (8 marks)

(b) **Explain the concepts of accountability and responsibility, using the comments of the institutional shareholders in the scenario.** (8 marks)

(c) **Assuming the company DOES need to find a new CEO, discuss the factors likely to affect whether the candidate comes from inside or outside the current board.** (10 marks)

(d) **Define the term "risk appetite" and discuss who sets the risk appetite at Reassurance.** (8 marks)

(e) **Write a letter on behalf of Harvey Lewis to Seven Investments describing the risks involved in a company like Reassurance taking over a company like WIF.** (16 marks)

Note – 4 professional marks are included in the mark allocation of part (e) for the clarity and structure of the letter.

(50 marks)

Section B – TWO questions ONLY to be attempted

2 Wolf Industries has had a bad few months. Its share price has lost more than half its value, several major customer contracts have gone to competitors, and many commentators believe the company may struggle to survive unless it puts through significant changes in the near future.

Professor Lee Sanchez, speaking at a business conference, highlighted his concerns with current corporate governance requirements in the area of board performance. He noted that despite the need for annual board evaluations, the first that shareholders knew of company problems was typically when the share price collapsed. He suggested that the current system of board evaluation was pointless, and that a poorly performing Chief Executive Officer (CEO) could easily hang onto his job and massive salary for months if not years. He went on to say that similar problems existed in director pay, with senior directors earning millions of dollars despite companies making losses, a growing amount of strike action by employees, and no obvious improvement in corporate social responsibility.

Required:

(a) Describe the difficulties with the current requirements for evaluating a board of directors and evaluate possible solutions to these difficulties. (8 marks)

(b) Discuss the professor's comments about the problems in getting rid of a poorly performing CEO. (7 marks)

(c) Suggest how a director's remuneration package can be designed to address the concerns of Professor Sanchez. (10 marks)

(25 marks)

3 Mark Wilson is in his third year as an audit trainee with the firm of Howard and Partners. He has recently been involved in the audit of the financial statements of Francis Components, a listed company. He became concerned after overhearing a telephone conversation being made by the chairman of Francis Components, in which he clearly heard comments suggesting that the annual evaluation of the company's internal control systems had involved nothing more than two of the directors agreeing that the control systems were fine and no investigation was necessary.

The draft annual report of the company has been shown to the audit team, and it includes a section describing a detailed controls evaluation, something Mark is convinced has not taken place. He is a little unclear of his responsibilities in this situation, and has told the audit manager that he remembers reading somewhere that in the USA auditors have an increased responsibility when it comes to listed clients and their control systems. He cannot remember any more detail about this, or how it might differ with the UK. Mark is unsure of what to do next, especially as he suspects the audit manager is not interested in this issue and intends doing nothing about Mark's concerns.

Required:

(a) **Explain the importance of a company carrying out regular evaluations of their internal control systems.** (6 marks)

(b) **Define the term "probity" in the context of good corporate governance, using the scenario to illustrate your answer.** (4 marks)

(c) **Describe an external auditor's responsibilities regarding the evaluation of a listed company's internal control systems in the UK, addressing Mark's comments to the audit manager.** (8 marks)

(d) **Compare and contrast deontological and teleological (consequentialist) approaches to ethics and suggest how Mark might deal with the situation at Francis Industries under each approach.** (7 marks)

(25 marks)

4 BlueSky Airlines is a major international airline. Last year the usually quiet Annual General Meeting gained a large amount of press attention after a group of shareholders representing 13% of the total ownership were able to force a resolution onto the agenda of the meeting. They called for the board to provide significantly more detail on what they were doing to address environmental damage being caused by the company's aeroplanes, forcing the board to spend over two hours at the meeting defending the company's business operations.

Required:

(a) Using normative/instrumental forms of stakeholder theory, explain the possible motives behind the actions of the shareholder group in forcing the resolution onto the AGM agenda at BlueSky Airlines. (6 marks)

(b) Using the Gray, Owen and Adams model of corporate social responsibility, explain how the board would react to the shareholder group from the pristine capitalist, expedients, and social contractarian positions. (9 marks)

(c) Explain what is meant by "active engagement" of shareholders with the board of directors, using the scenario as relevant. (5 marks)

(d) Define "full cost accounting" and explain the problems in applying it at a company like BlueSky Airlines. (5 marks)

(25 marks)