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School of Business
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ACCA

Paper P1

Governance, Risk & Ethics

Revision Mock Examination

December 2012

Answer Guide

Health Warning!	
How to pass	Attempt the examination under exam conditions BEFORE looking at these suggested answers. Then constructively compare your answer, identifying the points you made well and identifying those not so well made.
How to fail	Simply read or audit the answers congratulating yourself that you would have answered the questions as per the suggested answers.

Question 1

Tutorial help and key points

This question is a typical P1 case study, with the main focus being on governance and risk. As usual, there are professional marks to be earned, in this case by writing a letter to an institutional shareholder. The key is to use the **requirements only** to do an initial plan of content, and answer structure – then add information from the scenario to each part of your plan as the second stage. You are then ready to write your actual answer. Let the mark allocation guide you as to how much to write – 2-3 lines of writing per mark is a good target.

Notice how many marks can be earned simply from the requirements, and in every part of the question.

Part (a) is mostly knowledge, as the scenario simply illustrates the points you should already have worked out from the requirement – notably that the SID (in Singapore = LID) is there for the shareholders when they have a lack of faith in the chairman.

Part (b) requires two definitions, and application to the case. Key point here is that responsibility can be delegated (and has to be – you cannot be responsible for everything in a big company) whereas accountability comes with the senior position you hold and cannot be passed to others.

Part (c) requires a little thought, but could equally be asked about appointing anyone to any job. There are clear benefits to using insiders, but a much bigger pool of outsiders! But use the scenario! Bear in mind the whole board stood as one behind the failed strategy, so maybe an external candidate is essential.

Part (d) – think about the story. An old traditional company suggests a very embedded low risk culture. A massively high risk strategy is suggested, and the shareholders reject it. Seems like the shareholders (as well as the embedded culture) are setting the appetite!

Part (e) is quite tough. Some of the professional marks are clearly for letter structure, with an intro and conclusion. But what is the correct tone of the letter? The shareholder wants to see evidence that the risks had been identified, but the board said the deal was good – so your letter needs to identify the risks but also sound like they were risks worth taking. Making the deal sound terrible would be totally contradictory to your board's plan to do it! The content – think of as many risks of taking over a failing, massive, overseas company. In a recession. After a recent real-world history of failed massive takeovers (RBS, Bank of America, Lloyds). And you only need 6-8 risks in all likelihood.

Marking scheme

(a)	For each role (SID/LID): mark – up to 6 marks (chairman) and 2 marks	max 8

(b)	Definitions:	up to 2 marks each based on clarity
	Application to scenario – up to 2 marks per point made (max 4) based on quality of explanation	
(c)	Factors: up to 2 marks each	max 10
(d)	Definition: up to 2 marks each for attitude and capacity,	max 4
	Up to 4 marks for analysis of who sets it, based on quality and link to story	
(e)	Professional marks – 1 for structure, 1 for Intro and Conclusion, up to 2 for tone, clarity, tone that deal was right strategy	max 4
	Content – for each well-explained risk up to 2 marks, based on quality of explanation and link to scenario	max 12
		Total maximum marks = 25

(a) Roles of Chairman

The Chairman's primary role is to run the Board in a way that maximises its effectiveness.

This will require the Chairman to continuously consider whether the Board could be improved, for example by the addition of new people or the removal of current members.

In running the Board, the Chairman will need to ensure that good quality board meetings take place, with an agenda that is based on key strategic issues and which is sent to directors with enough advance notice to allow them to consider the issues before the actual date of the meeting. If documents are to be discussed at the meeting, these should also be sent to all directors in a timely fashion to allow them to be read before the meeting takes place.

The Chairman also has the responsibility to chair the board meetings, ensuring that the agenda is followed, the meeting keeps "moving" and that all directors have the opportunity to contribute.

The Chairman must organise, at least annually, a performance evaluation of the Board as a whole, of each Committee, and of each individual director. The results of this evaluation must be reported within the company's Annual Report.

The Chairman is the main communication point for the shareholders and must ensure that shareholder views are communicated back to the rest of the Board. This also works the other way around, as the Chairman will present the Annual Report and AGM and therefore reports the views of the Board to the shareholders. Often the Chairman will also seem to become the "face" of the company, being responsible for press statements, stock exchange announcements etc.

Where there is a dispute between board members, the Chairman will typically be the mediator who has to try to resolve it. When the Board is split on a decision, the Chairman will have the casting vote.

Roles of SID/LID

The SID's/LID's role is in effect to be the leader of the non-executive directors (NEDs), and he is likely to chair any meetings that the NEDs have without the Chairman or Executives present.

The other main reason for having a SID/LID is to clearly identify someone who is available as a contact for shareholders in the event that they prefer not to go to the chairman – for example, if it the chairman's performance that concerns them.

When a company is seeking a new chairman, the SID/LID is likely to chair the nomination committee meetings in order to manage the process.

The Case

It is clear that shareholders are concerned that the acquisition deal was ever proposed in the first place. As the person in control of the board, the chairman is therefore coming in for criticism as "his" board recommended the deal. The chairman would also have been the one who told dissenting board members that once the decision is taken, the whole board should act in a united fashion (at least to the outside world), a clear example of his mediation/team captain role.

The fact that shareholders are now talking to the SID/LID is a demonstration of the benefit of having a SID/LID – there is clearly a lack of faith in the chairman's ability, or a concern that he is too supportive of his CEO's risky proposal, so shareholders are happier talking to somebody different who is still seen as senior enough to be able to deal with their concerns.

(b) Responsibility

Responsibilities are usually part of a defined job role. For example, a CEO is responsible for running a company.

However, at higher levels in an organisation it is physically impossible to be directly responsible for everything, and so responsibilities tend to be delegated down the management hierarchy.

Accountability

Whilst responsibility can be delegated to others, often out of necessity, those in leadership roles retain overall accountability for the performance of a company. Therefore, when a team is deemed to have performed poorly, it is often the team manager or captain who is forced to go as the problems happened "under their watch", even if they were not directly responsible.

The Case

It appears clear that the strategy choice came from the CEO, so if the strategy is rejected as poorly thought out, the CEO is responsible.

However, the CEO presented his strategy to the board, and the board decided to adopt the strategy. The chairman leads the Reassurance board, and therefore allowed this decision to be taken. It can therefore be argued that the chairman (and potentially the board as a whole) is accountable, and should be held to judgement by the shareholders.

Even those directors who opposed the deal seemed willing to agree to stand united after the decision – they could of course have refused and voiced their

concerns, although they probably chose not to as this would have made their positions untenable and they would almost certainly have had to resign.

If the acquisition had gone ahead and been a failure, it could also have been argued that the shareholders would now be accountable – the company belongs to them, and all directors were appointed by them, so whilst as agents they have chosen to delegate running the company to the board (and therefore passed responsibility to the directors), many argue that when companies fail the shareholders should take at least part of the blame.

(c) Factors

The most important issue is that the company will want to appoint someone of sufficient overall quality. The board will have a small number of members, whereas the outside world is clearly a larger pool to select from and is therefore statistically likely to have better candidates.

However, those already on the board will already know and understand the company and the industry whereas outside candidates would need some form of induction period before they were fully "up to speed". This appears to favour internal candidates, but of course "knowing" the company can sometimes be a hindrance, because internal candidates see things "the company way" and appointing someone already on the board may lead to a resistance to change. Given recent events at Reassurance, an external candidate may therefore be a better approach.

A major concern when appointing a new CEO is the time factor. Good quality external candidates are likely to be in senior positions at other companies and would potentially not be available for several months, due to having to serve notice periods. An internal candidate could be appointed immediately.

It should also be appreciated that if an internal candidate is promoted to CEO, this creates a second succession planning issue – as the new CEO leaves a vacancy in whatever role they had been serving on the board. However, it is likely that it is easier to fill a role of lower seniority than it is to find the right CEO.

Investor reaction is another important factor, especially when a company is in a difficult position. Given recent events at Reassurance, shareholders may lack trust in any member of the current board, and may prefer an external candidate as a sign from the board that they accept that real change is required. On the other hand, shareholders may be more willing to accept one of the dissenting directors as the new CEO, as their opinion of the deal matches what the investors thought.

Overall, investors may wish to limit the amount of further upheaval and turbulence. If other members of the board (eg, the chairman) also leave at this point, there may be a preference for an internally appointed CEO in order to avoid two external candidates joining the two most senior board positions at the same time.

(d) Risk Appetite

An organisation's risk appetite describes the amount of risk that the organisation desires to take. It can be affected by a number of factors.

The risk attitude of the key stakeholders is probably the biggest contributory factor to the overall appetite. Just as people who enjoy food are likely to have a healthy appetite, so directors who enjoy taking risks are likely to feed their desire through the company where they work.

However, it is not just the directors – as agents of the shareholders, directors cannot ignore the risk attitude of investors. If shareholders believe a director is too much of a risk-taker, they are likely to want him to leave (or maybe appoint several risk-averse directors to balance him out).

When a company has high levels of debt, lenders (eg, banks) will also have an impact on risk appetite as they will communicate with the board when they fell that too much (or not enough) risk is being taken.

In some industries, other stakeholders such as customers, suppliers, or regulators also have an influence. A company's (and industry's) culture also has a big impact – it can be difficult to change an existing risk appetite if it is deeply embedded in company culture and industry conventions.

Reassurance

Given the company's involvement in financial services, regulators are likely to have an impact on risk appetite at Reassurance. The failure of a large insurance company, especially given recent failures of other large financial institutions, would not be an event that most governments would be prepared to risk.

However, the biggest factor at Reassurance appears to be the attitude of the shareholders to risk. The CEO's proposal has been seen as too big a gamble given the size of the acquisition, the huge expense in terms of professional fees, the lack of knowledge and experience in the target's country, and the inherent weakness of the target company's recent performance. The company is old and appears to be relatively averse to major change – this has attracted long-term shareholders looking for steady risk-averse performance, rather than short-term investors looking for a big quick gain.

The fact that some of the board were opposed to the acquisition shows that at least some of the board were similar in attitude to the shareholders, showing that maybe the CEO will find it difficult to stay at Reassurance as his strategies may always be viewed with suspicion.

(e) Letter

Reassurance

1 Any Street

London

Seven Investments

(address)

12 December 2012

Dear (name of contact at Seven Investments)

As discussed in our recent communications, I am writing in reference to the recent strategic decision not to proceed with the acquisition of WIF. Despite your Board's decision to proceed with the strategy of acquisition, we have now chosen to reverse the decision as it became clear that the proposed rights issue was not going to be accepted by our shareholders. The purpose of this letter is to assure you that we did a full detailed analysis of all aspects of the acquisition, and still believe it to be the right way forward for Reassurance. Clearly we have not done a good enough job in justifying this strategy to our shareholders, including yourselves.

Risk Analysis

Clearly, an acquisition of this size represents a risk in itself. The transaction would represent one of the largest in company history in this country, and as such it demanded the most thorough analysis and consideration that was possible. The sheer scale of the deal would require a major change to our company's finances, and whether we raised the money through debt or new shares (or a combination of the two), the analysis we did needed to give those providing the finance enough assurance that the deal's merits outweighed its costs.

The target company itself has had major troubles in recent times and only survived because of government support. However, its problems are mostly in the past, and its history and market position present us with a major opportunity to get immediate presence in one of the fastest growing economic areas in the world. Any attempt to grow there internally rather than through acquisition would take years, as we have almost zero presence there at the moment.

The main risk is the danger of paying more than the true value of the company. As we have seen from recent events in the financial services industry, establishing the true value of assets and liabilities can be extremely challenging and with a deal of this size even a small percentage overvaluation can lead to losses of hundreds pf millions of dollars. To address this issue, we took professional advice from the leading firms available – the fees we incurred are not small, but in return they provide a great deal of protection against future problems.

It should also be noted that WIF is already up for sale, and the fact that the current owners actively want to sell puts us in a better negotiating position than if we had approached them first.

Any acquisition of an overseas company presents risks, and the fact that WIX is in a completely different part of the world can increase some of these:

- Being in a different part of the world exposes us to a different system of laws and regulations, and we would need to fully understand the implications of these in order to maximise our returns. However, bear in mind that WIF is already part of an international group and thus the process of understanding differences in laws and regulations is an established process within the target company – the process does not have to start from scratch.
- Operating culture also varies between countries, and our lack of presence in this part of the world steepens our learning curve. Culture is something which cannot be fully learned, it is something that comes largely from experience. If we tried to establish our company in this part of the world on our own, we would miss out on a great deal of local knowledge. By acquiring an existing prominent company, we acquire their knowledge as well as their more tangible assets.
- The acquisition would expose us to foreign exchange risk, but as a financial services company with a long history we have the skills and experience to deal with the hedging issues that arise.
- Expanding overseas adds to the challenge of effectively controlling the new larger organisation. As you might expect, we had already started to identify key individuals who would relocate in order to ensure the main Board were always in full control of the overseas operations.

In practical terms, one of the biggest challenges in an acquisition of this size is the integration of the two entities after the transaction is completed. This is a process which cannot be forced through too quickly, or it is guaranteed to fail. We are fully committed to long-term value as we know our shareholders are, and as such our plans were designed to restructure and integrate slowly. This would mean no likely return on the acquisition in the short term, but a safer return in the medium to long term.

There is little doubt that we need to consider having a presence in parts of the world where the Economies of leading countries are strong, so it is not about whether we invest there but how – and the Board remains sure that this acquisition is the best way.

Kind regards

Stefan White

Chairman CSHB

Question 2

Tutorial help and key points

Part (a) of this question is very topical, as the UK CG Code has recently been changed to enforce an EXTERNAL board evaluation at least every third year. And your examiner has never set this part of the syllabus.

Part (b) has come up before, suggesting it could easily come up again. It requires some thought as it is an "opinion" question rather than facts to learn and repeat. But in **(c)** you have a great opportunity to present virtually everything you know about how to link director pay to performance – just make sure you use the professor's comments and include CSR.

Marking scheme

(a)	For each relevant difficulty	1 mark/max 4
	For each solution	1 mark/max 2
	For each evaluation of each solution	1 mark/max 2
(b)	For each relevant point discussed	up to 2 marks/max 7
(c)	For each suggestion	up to 2 marks/max 10
		Total maximum marks = 25

(a) Difficulties

Most codes of corporate governance require the chairman of the board to run an "effective" board. In order to monitor its effectiveness, regular board performance evaluations should be performed, covering the board as a whole, each committee, and each individual director.

Typically, the evaluation method is left to the individual company to decide. In the UK, a formal evaluation is required annually, but there are no further details in the requirements – except that the board performance evaluation must be done by an external party at least every 3rd year.

The lack of detail noted above is itself one of the difficulties, as companies may feel a lack of guidance as to how the evaluation should be carried out, and who should perform it.

Evaluating a board of directors, or a committee, may be extremely difficult as it is not immediately obvious what specific performance criteria there are to be measured. The board has such a "global" role that defining specific variables that can be linked directly to the actions of the directors may be very difficult.

Another problem is deciding who is in a position to carry out the assessment. Many companies do the assessment internally, with the board in essence evaluating itself. However this task is split up (eg, CEO evaluates other

Execs, SID (LID in Singapore)/Chairman evaluates NEDs, NEDs evaluate Chairman), there is a clear self-review threat to the independence of the process.

In fact, the very fact that the Chairman is responsible for carrying out an assessment of the Board that is run by the Chairman has inherent self-review threats from the start. Many have noted that boards that perform well tend to carry out a quality assessment, whilst the boards that would benefit most from an assessment do something far less formal and useful – surprisingly enough, bad quality boards have no desire to prove how bad they are.

If it is not to be the board who assess themselves, then the next problem is finding someone with enough knowledge of the board and its activities, as well as the necessary skills and competence, to perform a meaningful assessment. If it is someone external, confidentiality also then becomes a major issue.

Solutions

The independence problem can be solved by taking the responsibility for the assessment away from the Chairman and giving it to an independent external party, for example the company's auditors, or some other external expert. If there is a concern over a lack of knowledge, this external party could conduct interviews with board members and with sub-board management, to gain an insight into performance.

This process may require an expert to spend several weeks inside a company, in order to pick up a true picture of how the board operates.

In terms of how to evaluate a board, guidance should be developed to provide some standard performance indicators, and to suggest some non-numerical measures that could be useful as part of a balanced overall assessment.

(b) Comments

The Professor's comments seem to link weaknesses with the current system of board evaluation with the difficulty in getting rid of a poorly performing CEO. He comments that a collapsing share price may be the first indicator to shareholders that there is a problem. In other words, share price may be a valid tool for measuring a CEO's performance, and may in fact be the best way – but by the time it shows the poor performance, it is too late.

The typical CEO has risen to this senior position because they are very strong negotiators and very good at arguing their position and opinions. If a CEO is criticised for poor performance, but there are no quality tangible measures to prove the criticism, it is likely that the CEO will find counter-arguments and be able to end the debate.

A CEO will expect some support from fellow executives, and many of them may be wary of trying to remove him for fear of losing their own job if they fail. Directors/shareholders will be aware of this, and will worry that removing a CEO may lead to other executives leaving as well.

Another reason why a CEO is likely to be able to hang on to a job is that they are so hard to replace. There is a relatively small pool of people with the necessary skills and experience for any CEO job, and the current CEO will be well aware of this. Even where a replacement candidate exists, they may be

in another job and be required to serve out long notice periods, making it difficult to replace someone quickly.

Historically, boards (and shareholders) have seemed unwilling to "rock the boat" by removing a poor quality CEO, suspecting that unless the CEO is a complete disaster then it is probably easier to keep him and avoid the reputation damage, the time to find a replacement, and likely compensation payments. If the CEO refuses to resign, removing him would require the shareholders to have a general meeting and a vote, and this would attract the interests of the media and cause large reputation damage. It is hardly surprising that when a board want to get rid of a CEO, they try to convince him to resign rather than risk a prolonged fight in the public eye.

(c) Remuneration Package

Most people in employment are paid a fixed regular salary, but might have an opportunity to earn bonuses and other benefits if they perform well. This is also true of directors – but given they are running the company and are accountable for performance, the link between their reward and the company's results is more crucial.

A company's performance must be considered both in the long term and the short term, and since most people now seem to accept at least some corporate social responsibility, performance should not be seen purely in financial results, but in social and environmental measures as well.

Directors should have a large proportion of their remuneration linked to company performance indicators, including profits. But bonuses should only be awarded when the full long term effect of the company's operations can be seen with some level of certainty. It seems far too easy for a company to appear profitable in accounting terms today, only for this current activity to create unforeseen problems in the future that cause losses. Unfortunately, deferring bonuses can be a problem in itself, with directors receiving a bonus for a previous year's profits during a future year when the company might be making losses.

To encourage longer term performance, performance awards should not just be in the form of cash. Shares (which cannot be sold until some point in the future) or share options are therefore another useful way to pay directors.

Where the directors are entitled to receive "benefits in kind", these can also potentially be linked to performance. For example, the value of a company car could be set to increase as company performance improves.

One concern noted by Professor Sanchez is strike action. A common complaint is that when companies are performing poorly staff are expected to agree to pay freezes, job cuts and tighter working conditions – but the directors rarely seem to suffer any reduction in their own remuneration. One way around this is to link total director remuneration to total staff pay – if the staff wage bill must fall 10%, then the same should happen to total director pay.

When designing performance criteria, it should, as discussed above, not be based purely on financial profits. The professor mentions strikes and poor corporate social responsibility, and there is no reason why these cannot be factored in to performance assessment as well. Directors could be measured partly on employee relations, with the number of man-hours lost to strike

action, and the company's level of pollution (both statistics being measured against industry benchmarks) being measurable examples.

One of the most important issues is transparency – all of the above must be disclosed to shareholders in a clear and open way, so that it is easy to understand why a director earned the remuneration that they received. Backing this up with a binding shareholder vote on remuneration would also be likely to reduce the level of complaints.

Question 3

Tutorial help and key points

This is a mixed question, with internal controls, corporate governance principles and ethics all making an appearance. As always, a careful examination of the requirements is essential in answering the question.

Part (a) is all about IMPORTANCE, so ask yourself what would happen if companies did NOT evaluate their controls regularly.

Part (b) has a cg concept to explain (a regular requirement on the exam), and then to apply to the situation. You need to practise explaining these concepts.

Part (c) is harder and requires some knowledge of controls reporting and the audit process. On the other hand, there are several aspects of Mark's comments that need to be addressed – UK, USA situation, the false claims in the annual report of the client.

Part (d) has been asked this way before. The key is to explain HOW Mark might use the different approaches – you cannot say for sure what he will actually do (especially under the consequentialist approach) but you can say how he will decide.

Marking scheme

(a)	For each reason why important	up to 2 marks / max 6
(b)	For quality of definition	max 2
	For use of scenario	max 2
(c)	For responsibilities	1 mark each / max 4
	For each comment addressing Mark	up to 2 marks / max 4
(d)	For deontological / consequentialist	up to 2 marks each / max 4
	Mark	up to 2 marks for each of Deon / Conseq / max 3
		Total maximum marks = 25

(a) Importance

Every code of corporate governance, be it rules or best practice, requires company boards to have in place an effective system of internal control. As with anything that needs to be effective, performance needs to be regularly measured to assess whether it is effective enough in practice, whether effectiveness is falling over time etc.

To this end, corporate governance codes tend to not only demand an effective control system, but also demand regular evaluations to be carried out – so one reason the evaluations are important is that they are often a requirement, with potential fines or other penalties for non-compliance.

If evaluations were not carried out, there is a risk that controls would be failing (or about to fail) and no corrective action would happen. In some cases, a control can be so important that failing to evaluate whether it works can have catastrophic consequences – for example, if a smoke alarm is not regularly tested and nobody realises the batteries are dead, the only time this will be discovered is when people die in a fire because they had no warning to evacuate a building.

Evaluations may in themselves guarantee a strong control system, because if people know that someone will test a control they are more likely to ensure they fully understand their responsibilities to avoid being "found out".

Evaluations are also important in giving assurance to shareholders (and other stakeholders) that the company is well-controlled. Even if the evaluations do not discover any weaknesses and a system is running almost perfectly, knowing that a system is being regularly checked will reassure shareholders that the company is running efficiently, external auditors that they can safely reduce their substantive testing, lenders that it is safe to lend etc.

(b) Probity

The concept of probity relates to those in senior positions and who are therefore expected to be held accountable, but who have necessarily delegated some responsibilities to others (because as organisations grow, directors and senior management cannot be directly involved in every task).

For example, directors are accountable for the control systems in the company, but will not be carrying out systems evaluations themselves.

If directors are asked by shareholders whether control systems are working, they cannot simply say yes on the basis that they have not seen any problems – unless they are sure there are no problems because they have had the systems checked, or in other words probed. In a similar way, auditors probe the assertions made in financial statements – they do not just assume that directors have got it right, they are required to show professional scepticism and go looking for problems before giving their opinion.

There have been too many cases in the past where companies have collapsed, and it is then discovered that directors convinced themselves that everything was fine without actually checking – Barings Bank being a good example of this.

As a result, we could define probity as checking the accuracy of your opinions before voicing them, especially if others are likely to be relying on them.

In the case of Francis Components, it appears that the directors are willing to tell the shareholders that control systems are effective even though they have not carried out a formal evaluation. If they are claiming an evaluation has taken place, they should assure themselves of this before claiming it – and if they state control systems are effective, they should ensure that an evaluation has taken place and that any findings have been suitably dealt with.

(c) Responsibilities

In the UK (as in most countries), external auditors have a responsibility to report to shareholders on the truth and fairness of the financial statements.

There is no direct reporting responsibility on a company's internal control systems, or on a company's controls evaluation process.

However, this does not tell the whole story.

External auditors will assess and test the internal controls of all companies, because many of these controls are linked to the accuracy of the financial statements. Good controls help to provide some of the sufficient appropriate evidence which the auditors are trying to collect in order to form their opinion. Therefore, when auditors report that a set of financial statements is free from material error, this provides some indirect assurance that controls are working sufficiently well, at least in the area of financial reporting. Unless shareholders are well educated in the audit process, they may not get any assurances about controls from the audit opinion on the financial statements – but this does not change the fact that the external auditors are evaluating those controls and forming opinions on them.

Auditors will issue a report to those charged with governance ("management letter") detailing any material deficiencies in the control systems that were discovered during the audit. Whilst this helps management to keep controls effective, this management letter is typically for internal use only and does not therefore provide any direct assurance to outside stakeholders such as shareholders.

Auditors have a professional responsibility to read everything in the annual report because the annual report contains their audit opinion. If they read something which they know not to be true, they have a professional responsibility to ask the board to change the information. If the board refuses, auditors may need to communicate the error to shareholders beneath their audit opinion in the audit report, or at the AGM. Therefore, when companies report to shareholders on the effectiveness of their control systems (as UK corporate governance requires them to), the external auditors may find that themselves have to report something to shareholders if they know the company's disclosures are incorrect or misleading – and this would involve them commenting on the company's controls evaluation.

Mark's comments about the US are correct. The Sarbanes-Oxley Act requires the external auditors to give an opinion both on the financial statements, and also on the company's Internal Control Evaluation statement (a requirement for companies in their annual reports). In effect, this means the auditors are giving an opinion to US shareholders on the effectiveness of their client's control systems. UK auditors do not have a corresponding legal duty similar to this US requirement.

(d) Deontology and Teleology

Deontological ethics is based on the concept of duty. Deciding what is (or is not) ethical is based on a fixed set of rights and wrongs – as a result, some actions are unethical in themselves in all situations, without exception.

The feeling of "duty" to follow a particular code of behaviour can come from many sources. Some religions have a strict code of behaviour and followers are expected to abide by the code on all occasions.

Teleological ethics suggest that judging whether an action is ethical depends not on the action, but on the expected outcome of the action. This means that any action could be ethical or unethical, depending on the situation. This method of thinking becomes very complicated, as predicting the

consequences of everything you do is almost impossible, especially if you try to predict the indirect consequences as well as the direct. Egoists will limit it to the more simple act of trying to predict consequences to themselves – a good personal outcome makes the act ethical. Utilitarians go to the opposite extreme, trying to balance up the consequences for Society (ie, the Public Interest) overall. In the business world, we might take a middle ground and say that companies could consider their actions ethical if the positive outcomes to key stakeholders are greater than any negative outcomes to key stakeholders.

Mark has discovered something which appears to be unethical. The Annual Report of the client contains information which is clearly not true, and there is no obvious benefit to shareholders in being given this false information. If Mark thinks deontologically, he would presumably conclude that whenever an auditor finds false information being presented to shareholders, it must be corrected by the company, or the auditor must take further action. He would therefore not let this situation go unresolved, and would continue to push the audit manager until something was done. He might also believe that the audit manager's failure to respond to a clear problem is a breach of the manager's duty, and that he (Mark) must always report such breaches to the audit partner on the assignment.

However, a deontologist may also believe that in a hierarchy, you should always do what your manager/boss instructs you to do – because this is what holds an effective organisation together. He may therefore take the view that managers always know better than trainees and if his manager thinks the issue should not be taken further, then so be it.

If Mark thinks teleologically, he will try to assess the potential outcomes of his actions and choose an action which maximises the benefit. If he is an egoist, then he will try to get the best result for himself personally. This may be achieved by not upsetting the client and his manager, but equally he may feel that the audit partner would reward him for "blowing the whistle" on the manager.

If Mark thinks as a utilitarian, he will assess his options based on what is best for the Public Interest. He may therefore conclude that any positives or benefits for himself, the manager and the client are outweighed by the importance of accurate, transparent reporting – and that means the situation has to be followed up and brought to a resolution.

Question 4

Tutorial help and key points

For well-prepared students, there are several different theories in the question and therefore some relatively easy explanation marks on offer. For a poorly prepared student, any of the four parts could cause problems due to a simple lack of knowledge.

In **part (a)**, you will need to define normative and instrumental in order to then apply them to the shareholder group's actions. In essence the question is asking why are the shareholder group doing this?

Part (b) is a thorough test of Gray, Owen and Adams understanding. As with (a), a short definition of each of the 3 positions would be sensible, followed by an attempt to analyse the scenario from each perspective. To earn good marks here, the 3 pieces of analysis need to be clearly explained.

Part (c) should be fairly easy, as the shareholders are clearly being active in the scenario. But the answer still needs some thought or there is a risk of not actually saying much in your answer.

Part (d) is straightforward, and BlueSky represents a relatively obvious company to use as an example. The answer will mostly be straight out of the notes/textbook.

Marking scheme

(a)	For each definition of normative and instrumental	1 mark/max 2
	For each explanation of motivation	up to 2 marks/max 4
(b)	For explanation of each position	1 mark/max 3
	Reference to scenario for each position	up to 2 marks/max 6
(c)	For each relevant point	1 mark/max 5
(d)	For definition of FCA	1 mark
For each problem identified (must refer to BlueSky)		up to 2 marks/max 4
		Total maximum marks = 25

(a) Normative v Instrumental

Normative theory says that behaviour follows what is considered "the norm" – in other words, people do what they believe to be the right thing to do, because it is right in itself. They may feel it is "right" because it is what everyone else seems to do, because it is the law (and they believe that it is normal to abide by laws), because it is a standard, or because the person's principles make them believe that the act is right.

Acting instrumentally is where someone carries out an action because of the result they hope to achieve. The action becomes a "means to an end", and so the outcome is the deciding factor, not the action itself.

If the shareholder group have acted normatively, then they have made their "claims" on the board because they consider it the right thing to do. They may have deep environmental concerns, and bought their shares because they wanted to use their shareholder rights to change the airline's behaviour regarding pollution. Alternatively, they may not care personally about pollution, but feel that as shareholders they have ownership responsibilities and a duty to pass Society's concerns to the Board.

If the group is acting instrumentally, it suggests that they are trying to achieve a favourable outcome. They may believe that by appearing to be environmentally friendly, their own personal reputations as ethical investors are enhanced. If any of the shareholder group are institutional shareholders, this may be a deliberate attempt to "position" themselves as ethical investors, in order to attract more funds to their institutions.

Alternatively, the group may believe that environmentally friendly companies tend to attract more customers, and may believe that if they can get the board to do more about cutting pollution, the shares of the company will increase and hence the value of their shareholdings will improve.

(b) Gray, Owen and Adams

Gray, Owen and Adams have analysed seven different positions/opinions on the answer to the question of whether companies should have any responsibilities beyond the shareholders, and following the laws of the country in which they operate. In other words, whether companies should have any corporate social responsibility. The Pristine Capitalist position is that companies have no such responsibility. In fact, if directors spend any time and money on such areas (eg, donating to charity) beyond what the law requires, the directors are in effect stealing shareholder funds. Social responsibility is the job of government, not companies.

If the directors of the airline are pristine capitalists, then they are likely to reject the claims of the shareholder group. They will argue that they are not breaking the law, and that if Society wants less pollution then the government should create new laws – and then the airline would follow them. The board are no doubt happy to agree that pollution is a bad thing and may agree with the protestors that pollution should decrease – but the board would disagree that the company should be the ones to deal with the issue.

The Expedients position is sometimes referred to as "enlightened self interest". Here, companies choose to accept some social responsibility, but only to the extent that it is likely to result in an increase in shareholder value.

If the board view social responsibility in this way, they will only act to reduce pollution if they think it will improve the image of the company and lead to more profits. Alternatively, the board may believe that being seen to listen to shareholders is likely to attract new investors, and drive up the share price.

A social contractarian believes that companies have an "agreement" with Society that allows them to make profits, but only if they are willing to meet Society's demands in return. Therefore, if Society expects companies to have some social responsibility, then companies should have some – or leave that

Society and go and operate somewhere else where there is no expectation of corporate social responsibility.

If the board are social contractarians they will assess what Society thinks companies should do, and then they will do it. If Society is seen to believe that when shareholders make demands then directors should meet those demands, then they will meet the demands. If Society seems to feel that airlines do pollute too much and should try harder to reduce emissions, then the board will try to reduce emissions.

(c) Active Engagement

When directors are deciding how to deal with stakeholders (and in fact when stakeholders are deciding how to deal with directors) there are several methods which could be employed. For example, the stakeholders and directors may both choose to act passively and wait for the other party to come to them to communicate. This may result in agency problems, because no communication may ever take place resulting in the directors having no knowledge of the claims that stakeholders want to make on the company.

Whether we believe that directors only owe a duty to shareholders, or to a wider group of stakeholders, they cannot uphold this duty if they do not know what share/stakeholders want. As a result, corporate governance and legal systems are typically designed to encourage (and in some cases force) directors and stakeholders (particularly shareholders) to approach each other to communicate.

Under corporate governance, directors are encouraged to communicate regularly with shareholders and to assess the concerns of other key stakeholders. Part of the chairman's role is defined as being a point of contact for shareholders. Shareholders are also encouraged to accept ownership responsibilities and actively engage with the board, especially larger institutional shareholders.

The law requires companies to have an AGM in order to ensure that at least annually shareholders and directors have the opportunity for direct active communication, and shareholders have the ability to add to the AGM agenda to ensure that it is not just directors controlling the content of the Meeting.

In the scenario, we see shareholders using their legal rights to add a resolution to an AGM agenda in order to ensure a debate with the board. This is "active" behaviour. If the shareholders had not done this, no debate is likely to have occurred. The board are forced to listen to their views, and are forced to be accountable for their actions in the 2-hour debate which resulted.

(d) Full Cost Accounting

Full Cost Accounting (FCA) refers to a system where social and environmental costs and benefits are recorded alongside financial transactions in the accounting system. If taken to its limits, this would mean that a company reporting a profit have done so after taking account of all of the consequences of their operations. Supporters of FCA believe that whilst social and environmental performance indicators are disclosed outside of the accounting system, they will continue to be seen as of lower importance than the financial profit, and therefore true social responsibility will never be adopted by companies. Forcing companies to formally record the impact they are having on social welfare, pollution etc. will make it clear to everyone that

some companies are having a negative effect on Society and that change is therefore required.

Whilst it sounds like a sensible aim, FCA has some major obstacles to overcome before it can be adopted.

Firstly, there is the need to convince the business world that accountancy, an activity that has not seen great change in decades, needs a major overhaul. There are so many stakeholders in the business world that this in itself will be a difficult change in culture to achieve.

Secondly is the difficulty in measuring social and environmental cost and benefit. If figures cannot be estimated, then no accounting entries can be recorded. Many different estimation techniques may exist, and finding standards which are acceptable to all is likely to be a challenging process.

As well as the measurement problems, there is also an identification problem. Companies who are polluting are relatively easy to identify – but most companies will argue that their activities create a social benefit which would not be there if the company did not exist. Proving the existence of such "intangibles" will be far from easy.

Accounting standards are likely to have to change. For example, if pollution damage is expensed, presumably the company has to record a liability as the credit entry – but if the company has no duty to actually pay to clean up its damage, this would not meet the definition of a liability as no payment is ever expected.

The scale of environmental problems such as Climate Change, and the recent semi-collapse of the banking sector both provide a big impetus for change. Business cannot continue to push social and environmental issues to the margin, and that is likely to be enough motivation for something along the lines of FCA to be proposed in the near future.