APPROVED TEACHING RESOURCES ACCA

Mock One

Governance, Risk and Ethics

P1GRE-MK1-Z17-A

Answers & Marking Scheme

Paper P1

BECKER PROFESSIONAL EDUCATION®

1 HBHC

(a) Risks of integrating subsidiary into group

Integration risk

There is a risk that HBHC cannot be integrated into the TEC group using TEC's desired form of governance. If TEC insist on compliance, then there is the risk that this will be rejected by directors/employees in HBHC or that compliance will be limited as this form of governance is either not understood or simply not wanted.

The board of TEC must review the situation carefully. It may be better to allow HBHC to continue with the two-tier board system, as this is the country's standard form of governance, rather than risk dissent, as outlined above. Alternatively, the unitary board could be phased in over a period of time by, for example, building up the number of non-executive directors on the management board.

Culture risk

The different styles of corporate governance probably reflect the different styles of culture that the two companies operate under. Attempting to impose the management style of TEC on HBHC may cause resentment not only amongst the executive and senior management, but also amongst the workers.

As with integration risk, the board of TEC must fully assess the probability of culture clash and how this may be reduced and managed. Culture awareness, tolerance and culture management must be embedded in both entities. Many corporate mergers have failed because of a clash between cultures.

Technological risk

The development of the new fuel presents TEC with a technological risk. There is clearly the risk that the fuel will not work, or is found to be dangerous to use in untested areas such as high altitudes. Should the fuel cause a problem for aircraft using it, then presumably existing types of fuel could be used, so the TEC Company would not be adversely affected, apart from having no payback from the research and development expenditure. However, TEC could be affected by adverse publicity which could damage its reputation, which could lead to a fall in sales.

This risk will be mitigated by ensuring that the fuel is sufficiently well tested prior to release. The marketing director must also be careful to ensure that any release of information about the fuel identifies that this is research, and not yet a viable alternative source of fuel.

Reputation risk

There is a risk that the reputation of TEC will be adversely affected if the employee from the R&D department decides to provide information on the development of the new fuel. Whether or not HBHC did cause a leak of toxic gas into the environment may not be the issue, the adverse publicity is still likely to damage the reputation of the TEC group.

This risk could be mitigated by the establishment of internal whistle blowing procedures in HBHC and making available to all employees of HBHC the whistle blowing procedures of TEC. Until HBHC have such procedures, employees should have a direct line to the audit committee of TAC.

Tutorial note: *Award marks where reputational risk is considered to be the cumulative effect of all other risks and is mitigated by managing all such risks.*

Health and safety

There is also the possibility that HBHC breached health and safety guidelines. The comment that leakage was of "toxic" gas suggests this will be the case. Two types of breach of legislation are possible; firstly regarding health and safety at work and secondly regarding environmental contamination. If a breach is confirmed, then HBHC will be liable for fines and will also attract adverse publicity.

If there has been a breach, then the risk can be mitigated by reviewing current procedures to establish the reason for the leak and to instigate appropriate controls to minimise the risk of further leaks. HBHC should openly admit to the leak and state what remedial action is being taken to rectify matters. Although this may not stop fines being imposed, it would help protect TEC's reputation as the company will be seen to be attempting to remedy the situation.

If there was no breach, then it appears no action is necessary, apart from addressing the issue of whistleblowing, as mentioned above.

Business probity

TEC has received an order enquiry from a country which has a poor human rights history. Although there is no legal reason for not trading with this country, the board must consider whether HBHC/TEC want to be associated with sales to that country. TEC would, at the very least, attract adverse publicity from this move.

To mitigate this risk, the directors of TEC could choose not to supply the fuel distribution systems to this country. This decision must be balanced against their duty to look after the interests of shareholders in terms of providing them with an adequate return on their investment.

Control risk

Internal audit in HBHC focuses on checking the efficiency of the company's systems rather than their ability to prevent/detect error. There is a risk therefore that there are material errors in the systems of HBHC which are undetected. This will render HBHC's financial statements incorrect, and may have a material effect on TEC's consolidated financial statements, depending on the extent of any error. TEC would obviously like to avoid any negative effects of a qualified auditor's report.

To mitigate this risk, the internal audit department in HBHC should be properly funded and a full internal audit of the systems in HBHC carried out as soon as possible. Assistance from TEC's own internal audit department may be appropriate to facilitate the review.

(b) Environmental issues

An environmental audit will specifically investigate whether the activities of TEC are sustainable in terms of resource use compared to resource generation or recycling. Areas of an environmental audit, with specific reference to TEC in the scenario, are mentioned below.

Aircraft fuel consumption and carbon emissions

Aircraft, by their nature, emit significant amounts of CO_2 during flight. Various stakeholders will be interested in the amount of emissions generated:

- customers of air travel in case they want to offset their environmental footprint;
- customers of TEC for aircraft to show that they are purchasing products that are as environmentally friendly as possible;
- pressure groups who are concerned about the amount of CO_2 emissions;
- the government to decide whether or not to tax air travel more heavily to reflect the environmental damage.

TEC's purchase of HBHC was in part a reflection of this concern.

Specific indicators that can be used to determine the environmental impact of aircraft manufactured by TEC include:

- the amount of fuel used per kilometre travelled;
- the amount of CO_2 emission per kilometre travelled;
- as above, but based on per passenger kilometre.

This information can be made available for each aircraft type. Many new aircraft (e.g. the Boeing 787 "Dreamliner" and the Airbus A380) are sold using these indicators as part of their marketing profile.

Aircraft manufacture

As noted briefly in the scenario, aircraft manufacture involves the use of many resources. Taking the use of water as an example:

- The environmental audit will check both water usage, in terms of available supply, and water quality when it is released back into the environment. Specific environmental targets can be used.
- The amount of water used compared to TEC's "share" of water in its current locations. If water consumed exceeds water available to TEC, then manufacture is not sustainable.
- The amount of water consumed in the production process can easily be monitored using water meters. If necessary, targets can be set for consumption and actual usage compared to those targets. Determining the amount of water available is more difficult and will probably require third party assistance.
- For water quality, this again can be checked by sampling water released from TEC's factories. Standards of quality can be set and sampled water compared to these. The amount of acceptable "contamination" may be set by statute. However, TEC may choose to try and exceed those standards to show it has good "environmental" credentials.

Tutorial note: *Award marks for any other appropriate example of consumption of resources and energy.*

Social issues

Social issues relate to treatment of employees through to the company's support of the community and environment that it works in. Specific areas for social audit in the TEC group are identified below.

Treatment of workers regarding health and safety

Working conditions at HBHC may be a cause for concern with the possible release of toxic gas. Some of this gas could possibly escape into the working environment proving to be a serious hazard to the workers. This can be monitored by sampling the air for toxic chemicals and evacuation procedures initiated when such substances are detected. Performance indicators would be based on limits of toxicity (ppm) and regular dry runs of evacuation procedures (time taken to evacuate, etc). Systems could also be installed to shut down, extract and isolate the process and contain any leakage of toxic gasses. Performance indicators again would be based on the physical testing of the contingency plans for these systems.

Tutorial note: *In some systems, the plans will have to be tested through simulation (e.g. computer based). It would not be appropriate to deliberately release toxic fumes into the atmosphere to see what happened, although releasing non-toxic chemical fumes with similar but non-lethal properties would be possible to test the system.*

Adherence to health and safety legislation

The lack of appropriate environmental protection systems in the old aircraft hangar would appear to be a clear breach of health & safety regulations. A safe environment (e.g. sealed working areas) should be built in the aircraft hangar to ensure that toxic chemicals cannot escape into the general environment. This would also need to be supplemented by continuous sampling of air outside of HBHC's research facility and appropriate contingency plans operated in the case of a leak.

Performance indicators would normally take the form of number of incidents, fatalities, employees admitted to hospital

Stakeholders who would be interested in this information include:

- employees, to ensure that their working conditions were safe;
- local community who may be exposed to externally escaped toxic fumes;
- environmental pressure groups, normally to monitor company adherence to environmental laws and provide adverse publicity if this is not the case;
- the government, for law enforcement purposes;
- TEC shareholders, regarding company probity and whether to continue their investment in the group.

Support of the community

HBHC provides some community support (e.g. annual donations to local schools); it is not clear whether this has been extended to TEC or other subsidiaries. Again, targets can be set regarding the amount and form of school donations (e.g. money, equipment, people) and compared against previous years. Analysis could also be made to identify any correlation between the donations and recruitment.

With the sports facilities, performance measures would be based on the type of facilities provided, cost of upkeep and the use made of them by employees.

Stakeholders who would be interested in this information include:

- employees and the local community – to check that their company had appropriate social concern

- TEC shareholders – to check that the group and new company had the correct social concern – but perhaps not too much as this will decrease the return they obtain

- directors – in promotion of the company's and group's "image".

(c) Integrated thinking

As defined in the <IR> Framework, integrated thinking is the active consideration by an organisation of the relationships between its various operating and functional units and the capitals that the organisation uses or affects. It is the application of the collective mind of those charged with governance and the ability of management to monitor, manage and communicate (internally and externally) the full complexity of the value-creation process and how this contributes to the success of the organisation over time.

As integrated thinking leads to integrated decision making this will embed actions within the organisation that consider the creation of value over the short, medium and long term. These would include managing risk, in particular the risks described in part (a) above.

TEC is a highly sophisticated and complex industrial concern operating in an open and dynamic environment. The primary reason for the purchase of HBHC was to obtain the company's research and development expertise into new fuel types and engines that would use this fuel. This would complement TECs ability to use lightweight metals, plastics and composites to reduce aircraft weight – lower weight means less fuel, less fuel means lower weight, greater effectiveness in fuels means lower fuel levels for a given distance. A key performance indicator for aircraft is fuel efficiency – being able to reduce operating costs, fuel being the highest cost.

Failure to leverage the purchase of HBHC would not only be financially costly, but could also reduce the competitive advantage of TEC's aircraft.

Integrated thinking would enable TEC's board and governance to maintain an optimal balance of capitals (i.e. financial, manufactured, intellectual, human, social, relationship and natural). Their availability, quality and affordability can affect the long term viability and sustainability of TEC's business model and its ability to create value over time and react appropriately to the company's environment to ensure sustainable growth and value.

(d) Report to the Board of Tech Engineering Company

Subject: HB Humming Company

Remit: Corporate governance

We have been asked to review the corporate governance arrangements of HB Humming Company (HBHC) with particular emphasis on the differences between the governance of:

(a) The supervisory board of HBHC;
(b) Implementation of a unitary board in HBHC;
(c) Board committees;
(d) Auditors;
(e) Remuneration policy.

We detail below our findings together with our recommendations for your consideration.

We also take this opportunity to remind the Board, that as stated in the terms and conditions of engagement agreed by the Board on the 18th July 2016, our findings and recommendations are strictly for the use of TEC only and cannot be used for any other purpose than to enable you to formulate your plans in consolidating the corporate governance of HBHC into that of TEC.

A N Other

Lead Consultant

Investigation findings

Board structure

HB Humming Company (HBHC), the new subsidiary, uses a tiered-board management system to run the company – a management board with a supervisory board to oversee the activities of the management board. This is a system very popular in some European countries and in Asia. Obviously, this is a different approach to Tech Engineering's (TEC) unitary board structure. TEC may therefore perceive it advantageous to change HBHC's structure to be the same as its own.

However, as discussed below, the fact that TEC has always operated as a unitary board will provide challenges to understanding the difficulties, processes and cultural shift in moving a tiered-board to a unitary board. It is inadvisable for TEC just to demand the use of a unified board ("because that is the way we do things here") without being able to justify to HBHC why the changes should be made.

Supervisory board – extent of independence

The supervisory board of HBHC comprises 20 non-executive directors. Although this structure is good in terms of the supervisory board reviewing the management board, the members of that board may not necessarily be independent of the company.

- Employee and trade union representatives will attempt to have their interests discussed and met at the supervisory board meetings and may attempt to influence the management board to provide better working conditions, etc.

- The ex-CEOs will have been in charge of running HBHC at some stage. They are still in a position to influence the running of the company, and may object to decisions of the management simply because this was not the way they would run HBHC. Alternatively, the ex-CEOs could take a very lenient approach to the management board and not challenge sufficiently decisions made by that board knowing it is easier to let the board "get on with the job" of running HBHC.

- Similarly, the ex-Chairman may feel that he would be better at chairing the meetings and may wish to interfere or continually raise points of order.

- Major shareholders will usually have an agenda of maximising shareholder return. This may preclude HBHC's management board taking decisions which affect that return such as making charitable donations or retaining workers during periods of weak demand. Obviously this will not happen now as those shareholders have sold their shares to TEC. But if they remain on the supervisory board of HBHC, they may hold some grudges against the company and TEC.

Although there are independence problems, the main issue for TEC will be removing the supervisory board with the consequent loss of power for the employees, trade union officials, ex-CEO's and ex-shareholders. The vast majority of them would not normally be invited to join or be voted to a unitary board structure as non-executive directors.

The directors of TEC will need to explain in a positive way why the supervisory board is being disbanded.

The financial impact of this move in terms of broken service contracts will also need to be assessed.

Implementation of unitary board

Establishing a unitary board will involve various problems including:

- Finding independent non-executive directors to sit on the board. As already noted, many of the supervisory board members would not be independent (e.g. ex CEOs, employees, banks) or would not be considered as suitable candidates (e.g. trade unions). This may be especially difficult where the governance culture in HBHC's country is based on the tiered board system.

- Under TEC's corporate governance arrangements, at least 50% of the board should be non-executive. Some companies have boards comprising 75% non-executives. This means that either the management board doubles in size (and may thus be unwieldy) or half of the executive directors need to be replaced – an option that the current management board may well find hard to accept.

- Training the directors on the unitary board so that they understand their duties (which may be significantly different) and how unitary boards function (e.g. role of the NEDs). This will require providing them with the appropriate support.

- Establishing committees (e.g. the audit committee, nominations committee and remuneration committee) where these roles would have been undertaken by the supervisory committee (as a whole) or by the management committee.

- As the unitary board system is not the main method of governance currently used by HBHC, there is likely to be resistance to this move, both from the current management and supervisory boards, as noted above.

Board committees

From the information we were able to obtain, it is clear that the factors determining directors' remuneration are too narrow. In addition, the directors' contracts are excessive in the period of contract (six years) and method (rolling). Remuneration is discussed in greater detail below.

It is not clear how, and on what criteria, nominations to the boards are agreed.

The board of TEC need to ensure that HBHC has appropriate committees (remuneration, nomination and audit) in accordance with best corporate governance requirements. All of the committees should be suitably structured (e.g. all members of the remuneration committee must be independent NEDs; at least one member of the audit committee to have recent financial experience and all to be independent NEDs). All members of each committee must receive appropriate induction and training to ensure they are effective.

Appointment of auditors

In HBHC, external and internal auditors are appointed by the management board. For the internal auditors, this provides an independence problem because they are appointed by and also report back to that board. The board may choose not to take action on any reports from the auditors, and similarly the auditor may be threatened with removal if adverse auditor's reports are proposed. As noted above, there is no audit committee in HBHC. TEC need to address this deficiency as a matter of urgency.

Internal audit work

Internal audit department work is not focused on the detailed review of control systems. The term "business efficiency" implies that systems may be streamlined and controls potentially removed rather than the implementation of appropriate control systems.

To comply with TEC's standard of corporate governance, part of the work of internal audit will be to continually review and assess the control and risk management systems in HBHC. This will mean expanding the internal audit department, and possibly replacing the chief internal auditor, as he does not appear to have the necessary skills, experience and training to undertake this work.

Board remuneration policy

The current remuneration policy appears not to meet corporate governance regulations in the following respects:

- Remuneration is only reliant on one aspect of company performance, gross profit. Although this provides an incentive to directors to ensure that HBHC performs well, it is targeted at the short term and raises the risk that directors will manipulate financial results to achieve their remuneration and bonuses. A balance should be achieved between short and long term targets as well as other performance indicators (e.g. shareholder return, share price and strength of the statement of financial position).

- Service contracts appear to last for up to six years. This is inappropriate in corporate governance terms as this may provide significant payments for directors on breach of contract (e.g. on removal from office). Again, TEC needs to review this area and attempt to impose one year as the standard contract term.

- The provision for the Chairman and CEO to join the supervisory board at the end of the term of office appears to be an extension of their service contract. Under TEC's code of governance this should not be allowed. The removal of the supervisory board means that this practice cannot continue.

END OF REPORT

2 DAIRY UNIVERSAL

(a) Risk appetite

Risk appetite is the level and nature of exposure to risks a company's board considers desirable. It defines the board's willingness to accept risk. The board's attitude toward risk will depend on the organisation's ability to identify, assess, control and manage risks.

Market share

Dairy Universal knew of the dangers of adding melamine to increase the nutritional value of the milk and make their product more attractive in the market place. The board was prepared to accept the risk of selling a contaminated product in order to increase market share in a competitive market.

Moving into a new market

Moving into a new market will have higher risks than trying to increase sales or market share in an existing market. The board appear not to have the appetite for moving into a new market, but were prepared instead to use illegal means to increase their share of their current market.

The background of the board

As directors (including non-executive directors) are jointly liable for the action of the board as a whole the risk appetite of the company is a reflection of the individual risk appetite of each director. They were prepared not only to risk the reputation and viability of the company, but also their own personal reputations and probable prosecution/jail.

Reputation of the company

The directors took a huge risk by gambling on the company's good reputation (the packages had the Government's official stamp of quality approval). Usually a company of the standing of Dairy Universal would not have such a high risk appetite – if they did, appropriate controls would be in place to ensure that only safe ingredients were used in their products. But in this case, such controls were overridden by management.

(b) Potential risks

Health and safety risk

This is perhaps the most prevalent risk in this industry. Health and safety is paramount due to the nature of the product – baby milk. The source of the risk is the breach of relevant legislation relating to the strict requirement for the safety of the product. The likely effect would be seen as adverse publicity, fine payable by company, or legal damages payable (the death of babies). The worst case scenario could be closure of the unit producing the product or even the closure of the whole company.

Product reputation risk

This would arise through production of poor quality products that could result in product recalls, adding to the adverse publicity against the company caused by loss of customers. The end result would more than likely be loss of market share and finally the company filing for bankruptcy (loss of the social contract).

In the case of baby food, the companies might rely heavily on brand image and product reputation; an adverse event could put reputation and future sales at risk. Risk to a product reputation could arise from diverse public attitudes to a product or from negative publicity. This has been evident in case of the milk powder and the adverse reaction of the global customers who used milk powder for their products. As in the case of this scandal, the consumers kept buying the product that was seen as safe for their babies.

Legal or litigation risk

Risk also comes from the possibility of legal action being taken against an organisation. For example, tobacco companies have been exposed to legal action; food or drink providers are also aware of litigation risk from customers claiming that a product has damaged their health.

In the case of milk powder, the company faced legal action from the mothers of children who died or who remain in a critical condition due to kidney failure. The company knew about the risk of mixing toxic chemicals in the product, yet were prepared to accept that risk.

Regulatory risk

This arises from the possibility that regulations will affect the way an organisation has to operate. Regulations might apply to businesses generally (e.g. competition laws and anti-monopoly regulations) or to specific industries.

The case poses a potential risk for new entrants as it is very likely that after such an event regulations by government bodies will be tightened up as a response to this adverse event.

(c) Managing risk

Tutorial note: *As indicated in the requirement, the TARA framework is an appropriate framework and is used in this answer. Marks will be awarded for any other appropriate framework fully explained.*

Transfer

Transferring a business risk usually means insuring against the effects of the risk, entering into a joint venture or outsourcing.

In most jurisdictions it is a legal requirement for companies to have product liability insurance. However, the terms of any product liability insurance would not cover similar situations to that of Diary Universal as the company, through the directors, deliberately contaminated the milk. If this had been due to a manufacturing error, then compensation would be paid. Most likely the directors would be sued for personal damages as well as charged with criminal liability.

Avoidance

Avoidance of risk implies not undertaking the action that would lead to the risk. Business risks can be avoided by not being in that business – that is most likely not to be a practical option. Business is a risky operation.

To avoid the situation arising in Dairy Universal, new entrants and existing companies in the market would simply not contaminate their products in order to gain an advantage.

Reduction

Reducing risk concerns assessing the probability and effects of the risk and what steps should be taken to reduce both to an acceptable level.

Following the scandal, new entrants and existing companies in the market should review their quality control procedures to ensure anything similar would not be allowed. This may involve regular external independent testing of products with a greater oversight role being undertaken by non-executive directors.

Acceptance

The final strategy is to simply accept that the risk may occur and decide to deal with the consequences in that particular situation. However, the risk that is accepted should only be the residual risk, after having taken all appropriate action to transfer and reduce risk.

Existing companies in the market and new entrants should have reviewed their risk management systems following the scandal. Although they may have control over their internal systems, they will not have control over external events after their products have been delivered to customers (e.g. deliberate contamination of products on supermarket shelves) although this should be reduced where possible (e.g. using tamper-proof containers). This will be a residual risk (i.e. after having taken all other risk management actions).

3 MATRAXC

(a) Terms of reference – Remuneration Committee

Determine and agree with the board the framework or broad policy for the remuneration of the company's chief executive, chairman, the executive directors, the company secretary and such other members of the executive management as it is designated to consider.

The objective of such policy shall be to ensure that members of the executive management of the company are provided with appropriate incentives to encourage enhanced performance and are, in a fair and responsible manner, rewarded for their individual contributions to the success of the company.

Review the ongoing appropriateness and relevance of the remuneration policy, approve the design of, and determine targets for, any performance related pay schemes operated by the company and approve the total annual payments made under such schemes.

Review the design of all share incentive plans for approval by the board and shareholders. For any such plans, determine each year whether awards will be made, and if so, the overall amount of such awards, the individual awards to executive directors and other senior executives and the performance targets to be used.

Determine the policy for, and scope of, pension arrangements for each executive director and other senior executives.

Ensure that contractual terms on termination, and any payments made, are fair to the individual, and the company, that failure is not rewarded and that the duty to mitigate loss is fully recognised.

Within the terms of the agreed policy and in consultation with the chairman and/or chief executive as appropriate, determine the total individual remuneration package of each executive director and other senior executives including bonuses, incentive payments and share options or other share awards.

In determining such packages and arrangements, give due regard to any relevant legal requirements, the provisions and recommendations of corporate governance codes and the appropriate Listing Rules and associated guidance.

Oversee any major changes in employee benefits structures throughout the company.

Agree the policy for authorising claims for expenses from the chief executive and chairman.

Ensure that all provisions regarding disclosure of remuneration, including pensions, are fulfilled.

Be exclusively responsible for establishing the selection criteria, selecting, appointing and setting the terms of reference for any remuneration consultants who advise the committee.

Obtain reliable, up-to-date information about remuneration in other companies. The committee shall have full authority to commission any reports or surveys which it deems necessary to help it fulfil its obligations

(b) Internal control review

Reviewing the effectiveness of internal control is one of the primary responsibilities of the directors of a company. The actual authority to conduct the review may be delegated to the audit committee. However, the board will still be responsible for the statements on internal control in the company's annual report and accounts. It is generally expected that the review of internal control will be carried out annually.

The UK Corporate Governance Code (as an example of a non-rules based system) states that the board is responsible for maintaining a sound system of internal control to safeguard the shareholders' investment and the company's assets. The board should, at least annually:

- conduct a review of the effectiveness of the group's system of internal controls;
- cover all material controls, including financial, operational and compliance controls and risk management systems within their review; and
- report to shareholders that they have done so.

Management responsibility

Apart from internal audit, the main source of monitoring will be reports from management.

UK guidance from the FRC's *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting,* for example, notes that reports from the management to the board should provide a balanced assessment of the significant risks and the effectiveness of the control system in managing those risks.

As managers are the agents of the board, this assessment should provide an honest opinion of the internal control systems and make recommendations for detailed amendments where necessary.

Audit committee responsibility

An essential part of reviewing internal controls is the ongoing monitoring of the control systems. Regular reports will be expected on the operation of controls, usually from internal audit (will be from the two recently recruited managers) or from other internal and external monitoring.

The reports should be provided to the audit committee for their consideration. Summaries of these reports will then be forwarded to the board to assist in their overall monitoring function.

Board responsibility

The board is ultimately responsible for the ongoing monitoring of internal controls. It must therefore be confident in its own ability to carry out this task and ability to make a decision on the effectiveness of internal control. Reports from other sources including the internal and external auditors will be required where additional assurance is required.

The board review of the regular reports from management should:

- consider the risks identified by the reports and if they are significant;
- assess how they have been identified, evaluated and managed;
- assess the effectiveness of the system of internal control in managing the risks, having regard to any significant failings or weaknesses in internal control reported;
- consider whether necessary actions are being taken promptly to remedy any significant failings or weaknesses; and
- consider whether the findings indicate a need for more extensive monitoring of the system of internal control.

When considering their annual review, the board should also consider:

- the changes since the last assessment in the nature and extent of significant risks;
- the company's ability to respond to changes in its business and external environment;
- the scope and quality of ongoing monitoring of risks and the system of internal control;
- where applicable, the work of internal audit and other providers of assurance;
- the extent and frequency of the reporting to enable a cumulative assessment of the state of control and the effectiveness with which risk is being managed;
- the incidence of significant control failings or weaknesses that have been identified during the period;
- the extent to which failures resulted in actual, possible or potential future material effects on the company's financial performance; and
- the effectiveness of the company's public reporting processes.

(c) Rules-based corporate governance

Fraser Yale appears to be under the impression that unless the corporate governance requirements are enshrined as a rules-based system (e.g. Sarbanes-Oxley), some (if not all) of them could be ignored.

The pre-amble to the UK Corporate Governance Code explains the concept of a principles-based approach very well:

- The Code is not a rigid set of rules. Rather, it is a guide to the components of good board practice distilled from consultation and widespread experience over many years.

- Although companies are expected to comply wholly or substantially with its provisions, it is recognised that non-compliance may be justified in particular circumstances if good governance can be achieved by other means.

- A condition of non-compliance is that the reasons for it should be explained to shareholders, who may wish to discuss the position with the company and whose voting intentions may be influenced as a result.

- The Listing Rules require UK listed companies to describe in the annual report and accounts their corporate governance from two points of view, the first dealing generally with their adherence to the Code's main principles, and the second dealing specifically with non-compliance with any of the Code's provisions. The descriptions together should give shareholders a clear and comprehensive picture of a company's governance arrangements in relation to the Code as a criterion of good practice

Basically, although an element of the requirements may be considered not to be cost effective by Fraser Yol, care must be taken as not to implement them (and fail to give an adequate explanation) may result in the company's share price being negatively affected.

In addition, as Matraxc is in the process of seeking a listing, failure to comply with as many of the governance requirements as possible may affect the listing process.

4 CODES

(a) Internal control and fraud

Tutorial note: *Note that the examiner may draw upon relevant knowledge from underlying papers (e.g. F8).*

The following features of the system should help minimise the risk of fraud.

Risk assessment

Examples of procurement and purchase fraud include rigged tendering, goods being supplied for private purposes and fraudulent transactions with connected companies. In setting up a control system therefore, management should be aware of what kinds of fraud the business may be at risk of experiencing. One possible danger is collusion between the person authorising purchases and suppliers. Once purchases have been authorised, there may be nothing further that can be done to prevent fraud. The important controls therefore are normally those which are aimed at identifying unusual suppliers or circumstances.

Monitoring of suppliers

The risk of collusion between suppliers and employees can be minimised in a number of ways. For example, the person using the goods should only be able to choose suppliers from an approved list and the use of new suppliers should be authorised by someone other than the person using the goods.

The person authorising new suppliers should be particularly wary of any of the following:

- Abnormal terms;
- Suppliers providing goods which they would not normally supply;
- Suppliers which appear small compared with the proposed volume of purchases

In addition there should be regular monitoring by management of arrangements with suppliers. Warning signs should be investigated, such as suppliers handled directly by senior staff, or suppliers handled outside the normal control systems.

Controls in the payment cycle

Segregation of duties can reduce certain risks. Segregating the payment role from the authorisation role can reduce the risk that payments are made out to certain types of bogus supplier (e.g. those with abbreviated names). Part of the process of reviewing suppliers can be carried out at the payment stage, by checking that individual or total payments do not appear excessive.

Requirements for full documentation should be linked to segregation of duties. Full documentation would include purchase requisitions, purchase orders and purchase invoices. These can help prevent purchases for private use.

Documentation of returns is also important; credit notes should always be obtained from suppliers when goods are returned in order to prevent inventory losses through bogus returns.

Contract management

There are a number of different types of contract fraud including fixing the contract tendering process and undue payments in advance. Ways of preventing contract fraud include the following:

- An open competitive tendering process.
- Interim payments being made on certification from independent valuers.
- Any changes to terms being authorised independently of the person who deals with the contractors on a day to day basis.

Organisation and staff controls

References should be obtained for all new staff, and details retained of previous employers so that possible collusion can be checked.

A business code of ethics can remind staff of what constitutes unreasonable inducements.

Internal audit

Internal audit can play a role in a number of the above checks, particularly the following:

- Systems audit
- Procurement audits
- Fraud audit
- Risk audit
- Detailed checks of documentation
- Scrutiny of suppliers and payments for suspicious circumstances.

(b) Code of conduct

Aspects of the code which are acceptable

- The organisation has adopted a code of conduct which attempts to conform to customary business practices. It wishes to behave in a manner consistent with that of others in the market.

- The code appears to imply that employees can take slight risks and go beyond behaviour that might be construed as strictly correct in order to secure sales. It would be logical to do this in order to gain a sales advantage.

- The conduct of the members of the staff working in the purchasing function is controllable by the organisation and so the organisation can determine the code of conduct which should apply.

- The code of conduct covering the selling operation has to meet the expectations of the market and customers, however.

- The organisation has no control over its potential customers, who can decide whether or not they should accept any gifts, favours or entertainment offered.

- That part of the code of conduct relating to the purchasing activity is therefore necessarily stricter and more stringent than the part relating to the sales activity.

- Any gifts, favours and entertainment provided by a supplier benefits an employee whereas those provided for customers benefit the customer rather than the employee (unless the entertainment is lavish). There are therefore stricter controls over purchasing staff than sales staff.

Aspects of the code which are unacceptable

- The code fails to provide sufficient guidance on a number of matters. For example it does not specify the nature of customary business practices or common courtesies. Nor does it specify the exact legal requirements of the various jurisdictions operated within. Employees have no idea about whether they can offer a potential customer a glass of wine, a bottle of wine or a case of wine.

- The code gives no information about the repercussions for employees for contravening the code or law. There is therefore no indication of the seriousness with which the organisation views breaches of the code.

- The penultimate sentence about "favours or entertainment, appropriate in our sales programmes" implies a double standard and may encourage sales personnel to adopt a position which could damage the good name of the organisation.

- The unclear nature of the code relating to sales means that, because behaviour is not actually illegal, it may be adopted because it increases the organisation’s short-term profits (despite the fact that it might have longer-term repercussions).

- If performance measures are based on short-term profit, employees may feel pressurised into adopting unethical or even illegal behaviour.

Suggested amendments to the code of conduct

Given the above comments there are various amendments which could be made to the code of conduct to increase its acceptability;

- Ambiguous terms should be clarified.
- Penalties for contravening the code could be included.
- It could be drastically simplified and the entire section on business courtesies deleted since the information provided in the remaining section provides an adequate and concise code of conduct.
- The code relating to the conduct of employees working in the sales function could be rewritten with the intention of making it as strict and clear as that covering the purchasing function employees (no entertainment, no gifts and so on). There are commercial problems associated with such an approach, however; the market and customers may expect a more liberal attitude.

- Introducing a specific section on legal requirements (e.g. the UK Bribery Act 2010).

Such changes would produce an unambiguous, clear and concise code of conduct which will protect the integrity of the organisation and allow employees to be confident that their efforts for the organisation will remain within acceptable limits.

Marking Scheme

Marks

1 TEC

(a) Risk

Generally ***1 mark*** explaining risk and ***1 mark*** for mitigation.
SIX risks required, max of 2 marks each risk | max 12

Ideas

Integration risk (style of governance)
- Different styles of governance
- Rejection of change, change management failure
- Mitigation – keep two-tier system, slowly change

Culture risk
- Different countries
- Foreign management style may cause resentment
- Often main cause of merger failure
- Mitigation – assess potential effect, embed culture awareness and tolerance

Technological risk
- New fuel – may not work, dangerous
- Low or no return on investment in R&D
- Adverse publicity
- Mitigation – thorough testing, control publicity

Reputation risk
- Employee whistle blower
- Mitigation – internal procedures for whistle blowing

Tutorial note: *Award marks where reputational risk is considered to be the cumulative effect of all other risks and is mitigated by managing all such risks.*

Health & safety
- Toxic gas leakage
- Employee and environmental
- Adverse publicity
- Mitigation – improve controls, publically admit leak and action being taken

Business probity
- Order from military dictatorship
- Association with country
- Adverse publicity
- Mitigation – refuse order, balance with shareholders' interests

Control risk
- Internal audit – inappropriate focus
- Efficiency rather than effectiveness
- Under-funded, lack of experience
- Effect on information and financial statements
- Mitigation – increased funding to improve capabilities, assistance from TEC internal audit to improve experience

(b) **Environmental and social issues**

Generally ***1 mark*** each full explanation max 13

Ideas – Environmental issues

Use of environmental audit
Carbon emissions
Carbon emissions tax
Fuel consumption
Environmental footprint
- Stakeholders – passengers, buyers, pressure groups, government
- KPI – litres consumed/km, emissions/km, measures per passenger km

Aircraft manufacture
- Use of resources – water, power, raw materials, rare-earth metals
- Recycling of materials
- Stakeholders – suppliers, other users of resources
- KPI – resource taken out, resource returned (e.g. water), contamination, sustainability, recycling

Ideas – Social issues

Explanation of what social issues mean – employees, society, community
Workers
- Working conditions
- Health & safety
- Toxic fumes escaping
- Poor conditions in old hanger
- Lack of sealed environment
- Need for "sniffers" (samplers) and automatic shutdown systems
- Stakeholders – employees, environmental pressure groups, local community, regulators, shareholders
- KPI – results of continuous monitoring (ppm), number of incidents, strength of leaks, fatalities, hospitalisation, simulation of contingency plans

Community
- School donations
- Sports facilities
- Stakeholders – employees, local community, shareholders
- KPM – school donations made, type of donation, comparison with prior years, employment correlation, positive press coverage; type of sport facilities provided, cost of upkeep, use made of them by employees.

(c) **Integrated thinking**

Generally ***1 mark*** each full explanation — max 5

Ideas

Definition from Integrated Reporting Framework
TEC's business – sophisticated, complex, high tech, open and dynamic environment
Acquisition of HBHC for R&D on fuel
Complement TEC's current technology on metals, plastics and composites
Need to leverage acquisition
Maintain optimal balance of capitals
Sustainable growth and value

(d) **Board structures**

Generally ***1 mark*** each relevant point, with max of ***4 marks*** for each element. — max 16

Professional marks — max 4

Ideas

Report format, appropriate headings

Supervisory board structure and makeup
- Supervisory board lack of independence
- Employees/trade unions, ex-CEOs/Chairman, major shareholders
- Removing will result in loss of power for key players
- Financial impact – broken contracts

Problems of implementing a unitary board
- Finding independent NEDs
- Current size of management board
- Unbalanced executive structure
- Training directors
- Establishing committees
- Current board may resist

Board committees
- Directors' remuneration
- Nomination
- Audit
- Appropriate structure
- Training and induction

Auditors (internal and external)
- Currently appointed by management board
- Audit committee required
- Appropriate structure
- Training and induction of audit committee

Remuneration policy
- Narrow – related to profits
- Too short-term
- Balance required between short/long term
- Long service contracts -1 or 2 years not 6
- Chairman/CEO joining supervisory board– extension of service contract

50

Marks

2 DAIRY UNIVERSAL

(a) Risk appetite factors

Up to ***2 marks*** explaining each factor. 8

Ideas

Explanation of risk appetite
Market share
- Making product more attractive
- Aim to increase share in a competitive market

New markets
- Higher risks

Board background
- Board members jointly liable
- Board = sum of individual risk appetite
- Prepared to risk company and their own reputation
- Corporate and personal prosecution

Company reputation
- Good current reputation
- Government's official stamp
- High standing usually implies a lower risk appetite for use of dangerous substances
- Internal controls aim to prevent reputational damage
- Internal controls overridden by management

(b) Risks of entering market

Up to ***2 marks*** explaining each risk 8

Ideas

Health & safety
- Most prevalent risk in the market
- Product highly relevant – baby milk
- Highly regulated
- Potential negative effect includes adverse publicity, fines, legal damages, closure.

Product reputation risk
- Poor quality products
- Product recalls
- Loss of market share
- Loss of social contract, closure

Legal
- Legal action taken by consumers, mothers
- Example of tobacco
- Prepared to take risk of legal action

Regulatory
- General business
- Specific (e.g. health & safety)
- Likely to be increased regulation

(c) **TARA framework**

½ mark for explaining the risk management element plus up to ***2 marks*** describing its relevance to the scenario. Award marks for any other relevant framework that covers similar areas — max of 9

Ideas

Transfer
- Insuring, joint venture, outsourcing
- Product liability insurance
- Deliberate contamination by the directors would not be insurable (as accidental contamination may well be)

Avoidance
- Not undertaking the action that leads to the risk
- Avoid business risk means not being in that business - impractical
- Do not deliberately contaminate products

Reduction
- Assess impact and probability and steps that can be taken
- Review quality control procedures
- Regular independent testing of products

Acceptance
- Risk will occur
- Deal with consequences when and if they arise
- Residual risk after taking all other risk management actions

25

3 MATRAXC

(a) **Terms of reference**

1 to 2 marks each relevant point depending on depth of detail — max 10

Ideas

Agree with the board the remuneration framework
Appropriate incentives to encourage enhanced performance
Rewarded for contribution to the success of the company
Review ongoing appropriateness and relevance of policy
Approve performance related pay schemes and payments made
Review design of share incentive plans and approve total annual payments
Determine pension arrangements
Ensure contractual terms on termination are fair
Ensure failure is not rewarded
Determine total individual remuneration package
Oversea major changes in employee benefits structure
Agree policy for authorising claims for expenses
Ensure appropriate disclosure of remuneration
Exclusively responsible for dealing with remuneration consultants
Obtain reliable, current remuneration information on other companies

(b) Internal control

1 mark each relevant point. max 10

Must cover management, audit committee and board. As the board has ultimate responsibility, up to 50% of the answer can cover its role.

Ideas

General corporate governance requirement (e.g. UK CGC)
- Review of effectiveness
- Covering all material controls
- Report to shareholders

Management responsibility
- Reports from key managers (who are agents of the board)
- Balanced assessment of significant risks
- Effectiveness of control systems in managing risks
- Honest opinion
- Recommendations for essential changes

Audit committee
- Ongoing monitoring (24/7?)
- Internal and external auditor's reports
- Committee summarises and reports to board

Board: review of regular reports
- Ultimate responsibility
- Consider risks identified
- Assess effectiveness of controls in managing risks
- Consider if necessary actions being taken
- Determine if more extensive monitoring required

Board: annual review
- Changes since last review
- Company's ability to respond to change
- Scope and quality of ongoing monitoring
- Extent and frequency of internal reporting (see above)
- Incidence of significant control failings
- Failings leading to actual, possible or potential future material effects on financial performance
- Effectiveness of company's public reporting processes

(c) Fraser Yol

1 mark each relevant point made max 5

Ideas

Rules-based, principles-based

UK CGC pre-amble
- Not a rigid set of rules
- Non-compliance may be justified
- Need to explain non-compliance
- Shareholders need a clear and comprehensive picture of governance arrangements
- Potential effect on share price
- Potential effect on listing process

25

Marks

4 CODES

(a) Risk of fraud

Generally ***½ mark*** each feature discussed, ***1 mark*** each valid point made, ***½ mark*** for each example. Other relevant features should also be awarded marks — max 11

Ideas

Risk assessment
- Examples (e.g. rigged tendering, private purchases, fraudulent transactions with connected companies, buyer/supplier collusion)
- Need to assess fraud exposure

Monitoring of suppliers
- Strong procurement controls
- Approved list
- New supplier tenders aware of abnormal terms
- Regular supplier monitoring
- Warning signs (e.g. suppliers providing unrelated goods, small suppliers but large volumes, handled directly by senior staff, handle outside of normal control systems)

Payment cycle
- Segregation of duties (e.g. payment authorisation and bank payment)
- Full supporting documentation of purchase cycle
- Returns

Contract management
- Types of fraud (e.g. tendering, undue payments in advance)
- Open competitive tenders
- Use of independent valuers certifying interim payments
- Changes being independently authorised

Organisation and staff controls
- New staff references
- Possible collusion with previous employer
- Code of ethics

Internal audit
- Systems audit
- Procedures audit (e.g. procurement)
- Risk audit
- Fraud audit

(b) **Code of conduct**

Generally ***1 mark*** each valid point made max 14

Ideas

What is acceptable
- Adoption of a code
- Some flexibility on taking slight risks
- Conduct of employees controllable
- Has to meet expectations of the market and customers
- No control over decision making process of customers
- Stricter on purchases staff than sales staff

What is unacceptable
- No detail of nature of customary business practices
- Does not indicate what are common courtesies
- No detail of legal requirements (e.g. UK Bribery Act)
- No indication of repercussions for employees
- Potential double standard in sales programmes
- Code is unclear on aspects of sales
- Performance measures on short-term profits

Required amendments
- Clarify ambiguous terms
- Include penalties
- Edit and simplify
- Remove duplications (e.g. business courtesies)
- Sales function element should be stricter
- Add section on legal requirements (e.g. UK Bribery Act)
- Performance measures on short-term profits

max **25**

Q	Part	Topic	Study Text ref	RQB coverage	Commentary
1	(a)	Risk	12	Q18 Ultra-Uber Q19 YGT	A pass mark could be obtained by applying risks learnt from the Study Text to the scenario. Good candidates would have also identified other risks from the scenario to ensure maximum marks.
	(b)	Environmental and social issues	20	Q32 JGP Chemicals Q33 Deetown M/J16 Q4 WSK	A good answer requires analysis of the scenario, external understanding of the industry that TEC and HBHC operate in and the environmental impact.
	(c)	Integrated Reporting	20	S/D16 Q3 Oskal Petroleum	Good students would have noted that the requirement was on integrated thinking and would have "integrated" this understanding with an appropriate analysis of the scenario. Poor students may have included rote-learnt knowledge of <IR> in their answers which would earn few marks.
	(d)	Governance (board, committees)	3-5	Q5 Lum Q7 Zogs Q11 HWL	The professional marks were available for a report format (**not** a letter) clearly dealing with the five elements detailed in the requirement. A pass mark would be obtained by good analysis of the scenario with sensible commentary on each matter – only 1½ marks needed from each matter.
2	(a)	Risk appetite	12-14	Q21 Bob Wong S/D15 Q3(b) Branscombe	Poor students may have identified relevant factors of the entity's risk appetite, but would not have been able to give appropriate reasons. This approach would not have gained a pass mark.
	(b)	Risk	12	Q35 R & M Q36 Swan Hill	Identifying the potential risks to *existing* competitors **and** *new* entrants the essential to obtaining a pass mark.
	(c)	Risk management	14	Q19 YGT Q42 Hiaka Energy	Just giving a rote learnt explanation of each element of TARA would not gain a pass mark. Good students would have also linked each element into the scenario.

Q	Part	Topic	Study Text ref	RQB coverage	Commentary
3	(a)	Remuneration committee	5	S/D15 Q3(a) Branscombe	Candidates who were able to show that they had assimilated terms of reference through reviewing real life examples should have tackled this requirement well.
	(b)	Internal control effectiveness	9	Q23(c) Tzo Q37(c) Sea Ships D14 Q4 Loho	A good answer would have followed the requirement and given sufficient detail on management responsibility, audit committee responsibility and board responsibility to gain a pass mark.
	(c)	Corporate governance	1, 6	Q10 Geeland	Knowing the difference between rules-based and principles-based corporate governance distinguishes a good candidate from a poor one. Candidates who had read/browsed through the actual UK Corporate Governance Code should have been well placed to gain good marks.
4	(a)	Controls ad fraud	9	Q13 Yaya	Candidates who were able to draw upon their assumed knowledge of auditing should have done well.
	(b)	Code of conduct	18	Q38 Coastal Oil	A good answer requires not only book learning and understanding of illustrative codes, but also practical review of real life codes published by most listed companies on their websites.