



Mock One

Governance, Risk and Ethics

P1GRE-MK1-Z17-Q

Time allowed: 3 hours and 15 minutes

This paper is divided into two sections:

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

Section B – TWO questions **ONLY** to be attempted

Do NOT open this paper until instructed by the supervisor.

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

- 1 The Tech Engineering Company (TEC) is based in a country with a “comply or explain” regime of corporate governance that is considered to reflect best international practice. TEC is a listed holding company, with 10 wholly owned subsidiaries. The holding company and nine of the subsidiaries are located in one country. TEC’s most recent purchase, HB Humming Company (HBHC), is located in a neighbouring country.

Companies in the TEC group manufacture and produce a variety of aircraft from small passenger aircraft and military helicopters to some of the world’s largest aircraft which can be fitted to carry either passengers or cargo. The manufacture of aircraft uses a significant amount of resources including metals, composites and plastics as well as water, oil, etc. Opportunities for recycling old aircraft are limited given the amount and variety of materials used.

HBHC is currently managed and run on a two-tier board system. The supervisory board has 20 members and includes employees, trade union representatives, bank representatives, two previous CEO’s, a past Chairman of the main board and major shareholder representatives. Two members of the supervisory board are also members of the management boards of other companies.

Executive remuneration is closely linked to company performance, with rolling service contracts running for up to 6 years to reflect the security directors need in their positions. As with all companies in the country, the remuneration of senior management in HBHC is closely linked to the profitability of the business. 75% of senior management remuneration in HBHC is linked to attaining a gross profit target with additional bonuses as that target is exceeded.

The Chairman’s and CEO’s contracts contain clauses allowing them to sit on the supervisory board when their term of office expires, should they wish to do so.

The auditor of HBHC is appointed by and reports to the management board, likewise the chief internal auditor. The internal audit department has a very limited budget and consists of three employees. The chief internal auditor has no formal audit training or professional qualification and his two junior auditors have only just started studying for their ACCA qualification. Internal audit work is primarily focused on business efficiency and removal of unnecessary activities rather than a detailed review of the effectiveness of control systems.

The board of TEC have indicated that they would like HBHC to follow the same code of corporate governance as applicable to TEC so as to ensure conformity throughout the group.

The primary reason for the purchase of HBHC was to obtain HBHC’s research and development expertise into new fuel types. HBHC is currently trialling a new type of aircraft engine that can run on fuel grown from oil-based crops (i.e. bio-fuels). An unknown factor of using bio-fuels is what, if any, environmental damage this fuel produces when it is burnt at high altitudes. The board of HBHC are currently keeping secret the research and development process and results.

It is generally known by the managers and senior employees at HBHC that since the takeover by TEC, new research has been undertaken in an old aircraft hangar without the appropriate environmental protection systems to prevent leakage of toxic fumes into either the work areas or the environment. One employee is currently considering approaching the national press to disclose this information.

Sales for the TEC group have been below budget for the last two financial years. It is hoped that the purchase of HBHC and its technology will provide a competitive advantage.

HBHC has recently received an order to supply fuel distribution systems for a number of military installations (airfields and shipyards) which will guarantee the jobs of 750 HBHC employees for the next 3 years. This order is from a country with a poor record on human rights and is governed by a military dictatorship.

As part of its approach to being a socially responsible company and employee, HBHC provides sports facilities for employees and makes annual donations to local schools, from which many of its employees graduated.

Required:

- (a) **Identify SIX risks associated with the integration of HBHC into the TEC group and describe how each risk could be mitigated.** (12 marks)
- (b) **Explain the environmental and social issues of interest to stakeholders of TEC and suggest key performance measures that could be used to monitor those issues.** (13 marks)
- (c) **Explain why integrated thinking in the context of the Integrated Reporting Framework will be important to TEC.** (5 marks)
- (d) **Write a report advising TEC on the governance changes needed in the HBHC subsidiary. Your report should cover the following areas:**
 - (i) **The supervisory board of HBHC;**
 - (ii) **Implementation of a unitary board in HBHC;**
 - (iii) **Board committees;**
 - (iv) **Auditors;**
 - (v) **Remuneration policy.**

(16 marks)

Professional marks will be awarded in part (d) for the structure, logical flow, persuasiveness, and tone of the report. (4 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

- 2 In one of the world's largest developing countries, the food industry has been shaken by a recent scandal concerning milk powder. Dairy Universal, the largest producer of baby milk powder in the country, knowingly sold baby milk contaminated with melamine (an organic-based chemical poisonous when consumed) to make it appear higher in protein. The baby milk market was highly competitive and the company was concerned to protect its market share against threats from new competitors as well as to take market share from current competitors. In spite of knowing about the toxic content, the company had allowed around 900 tonnes of the milk powder to leave its factories.

At least six babies are known to have died as a result of drinking contaminated milk with many more being placed in intensive care because of damage to their kidneys. It was only when an overseas customer reported that they had found melamine in a consignment of milk powder that production was stopped at Dairy Universal and a government investigation carried out. Following the discovery, many milk powder-based products were recalled by their manufacturers. For example, European manufacturers who used the milk powder in various chocolate products had to recall all of their chocolate products to alleviate customer fears.

Although the government has scrambled to fight off allegations that it reacted slowly to the crisis, the scandal has damaged the country's reputation for producing safe and reliable food products. Even though the government has pledged to improve food safety standards, the fact that all food supplies (including the contaminated milk powder) carried the official government seal of quality, has added to the damaged reputation of the country's food industry. Parents who have used any milk product are terrified and the families of the victims say the government's lack of openness, public accountability and official corruption mean that they have little faith that similar poisonings will not happen again.

Required:

- (a) **Identify, with reasons, the factors that may have contributed to the risk appetite of Dairy Universal.** (8 marks)
- (b) **Describe FOUR potential risks for existing competitors and new entrants into the market place following the milk scandal.** (8 marks)
- (c) **Explain how new entrants and existing competitors could have managed the risks described in (b) using a risk management framework .** (9 marks)

(25 marks)

- 3 Angela Rae is chairwoman and chief executive of Matraxc, a private company that is planning to seek a listing on the local stock exchange within the next two years. She has already started to implement changes to the company in order to meet corporate governance requirements, for example employment of non-executive directors (NEDs), employment of two internal auditors and commencing a human resource search for an independent chair.

At a recent board meeting, one of the NEDs raised a number of issues concerning establishing various committees, in particular a remuneration committee, nomination committee and an audit committee. She was particularly interested in knowing what the terms of reference would be for each of the committees.

Another NED asked how the company was planning to meet the governance requirements on reviewing the effectiveness of internal controls. In reply, one of the executive directors, Fraser Yol, suggested that as the system of corporate governance in his jurisdiction was not rules-based, there was no need to follow all of the requirements. He also suggested that as they were a relatively small company, many of the requirements would not be cost effective.

Required:

- (a) **Draft an outline terms of reference for the remuneration committee.** (10 marks)
- (b) **Explain the need to review the effectiveness of the internal control system making specific reference to the actions of management, the audit committee and the board in the monitoring process.** (10 marks)
- (c) **Constructively criticise Fraser Yol's belief that there was no need to follow all of the corporate governance requirements.** (5 marks)
- (25 marks)**

- 4 One definition of an internal control system is that it is a process, implemented by the board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.

Required:

- (a) **Explain how a control system can help to minimise the risk of fraud in procurement and purchasing.** (11 marks)
- (b) Some codes of conduct appear to have a “double standard”. An extract from such a code is shown below:

Customer and supplier relations

The company does not seek to gain any advantage through the improper use of business courtesies or other inducements. Good judgement and moderation must be exercised to avoid misinterpretation and adverse effect on the reputation of the company and its employees. Offering, giving, soliciting or receiving any form of bribe is prohibited.

Business courtesies

Gifts, favours and entertainment may be given in the following circumstances:

- (i) If they are consistent with customary business practices;
- (ii) If they are not excessive in value and cannot be construed as a bribe or payoff;
- (iii) If they are not in contravention of applicable law or ethical standards;
- (iv) If they will not embarrass the company or the employee if publicly disclosed.

Gifts, favours, entertainment or other inducements may not be accepted by employees from any person or organisation that does or seeks business with, or is a competitor of, the company, except as common courtesies usually associated with customary business practices. An especially strict standard applies when suppliers are involved. Favours or entertainment, appropriate in our sales programmes may not be appropriate or acceptable from suppliers. It is never acceptable to accept a gift in cash or cash equivalent.

Required:

Discuss the acceptability of the above extract from the code of conduct recommending any amendments to the code. (14 marks)

(25 marks)

End of Question Paper