Mock Two

Governance, Risk and Ethics

P1GRE-MK2-Z17-Q

Paper P1

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 Petro Global is a multi-national oil and gas company with operations spanning three continents. In spite of a global recession the company has continued to record annual revenues in excess of $200 billion. The chief executive officer (CEO) of Petro Global remains committed to pursuing a profit and growth driven strategy and is considering a venture into the Arctic's oil and gas reserves. Although this vast region is home to many species of wildlife it currently has few internationally recognised wildlife protection areas. As far as consumers are concerned the priority is for cheaper fuel not wildlife conservation (as evidenced by the popular bumper sticker: "Who cares about polar bears? I want cheap petrol!"), and this is reason enough for energy companies to enter the area.

Although the Arctic represents the potential for huge future revenues, it also presents a significant environmental challenge to any energy company operating there. An oil spill would have a catastrophic impact on the survival of endangered species such as polar bears and caribou (reindeer), sea mammals and the way of life (which has not changed for thousands of years) of the indigenous population.

An environmental group representing the indigenous populations in one area targeted by Petro Global, has reported that the company uses dubious tactics in an attempt to gain the support of the inhabitants for the company to acquire the drilling rights for oil. For example, the company has paid for repairs to fishing boats, installed WiFi and internet networks and has provided free tablets to school children. Generally, companies such as Petro Global have invested heavily in the local infrastructure to make life "easier" for inhabitants. The environmentalists also argue that while Petro Global claim "we will use the latest technology, the latest scientific methods … every effort will be made not to have a spill", it will not explicitly say "If we have a spill we can clean it up", because they know they cannot.

Petro Global recently came under the media spotlight for arguing that investing in the development of alternative energy was too costly and that the expected return was too low. Although it had been one of two major investors in a British initiative to develop wind farms, it has since pulled out due to the level of costs and has now decided to invest instead in the Canadian tar sands. Environmental protestors at a recent climate summit described these thousands of square kilometres of oil tar-laden soil and sands as "dirty, toxic and huge". It is generally accepted that tar sands technology is one of the least environmentally-friendly ways of extracting oil.

Industry and academic governance experts argue that the current profit-driven business model is not sustainable and that the company displays a lack of interest in recruiting the new breed of non-executive directors (NEDs) whose priorities lie in environmental and social responsibility. According to a recent survey published in a quarterly management journal, 80% of applicants to Petro Global for non-executive positions have not made the short-list for a final interview. The reasons Petro Global cited for turning down applicants include the need for its NEDs to have oil and gas industry experience.

In addition, after revealing staggering profits of $6.4 billion in just three months, Petro Global is facing angry calls from customers and business leaders – who insist that these profits are obscene – to slash oil and gas product prices (particularly petrol and diesel) by up to 15%.

In summary, stakeholders (including several large corporate investment firms) in Petro Global have expressed growing dissatisfaction with the current strategy and with the next AGM fast approaching, Alex Hall, Petro Global's chairman, must address these issues.

Required:

(a) **Identify FOUR of Petro Global's stakeholders and explain each stakeholder's claim.** (8 marks)

(b) **(i)** **Describe the negative impacts the planned venture may have on the environment.** (4 marks)

(ii) **Explain how local and national governments may reduce the probability and impact of environmental damage.** (4 marks)

(c) **Discuss the two contrasting statements "Who cares about polar bears, I want cheap petrol!" and "We will use the latest technology, the latest scientific methods … every effort will be made not to have a spill" from the following ethical perspectives:**

(i) **Absolutism; and** (3 marks)
(ii) **Relativism.** (3 marks)

(d) **Draft a memo to Alex Hall to advise him on the role that non-executive directors (NEDs) would have in the development of a long-term sustainable strategy for Petro Global, which covers the following issues:**

(i) **An outline of the roles and responsibilities of NEDs;** (8 marks)

(ii) **An explanation of the concept of a social contract with stakeholders and the role of NEDs in developing that contract; and** (12 marks)

(iii) **A brief overview of a general induction process for new NEDs.** (4 marks)

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

(50 marks)

Section B – TWO questions ONLY to be attempted

2 Fling Exports is considering introducing a corporate air miles ("frequent flyer") scheme for its employees. Currently any air miles collected by employees through company business are kept by each employee for personal use. There has never been any formal policy on the use of air miles; it has never been considered and has just been accepted "as is". The new scheme would use company cards which would pool all the air miles for use by the company, thus reducing costs. Employees would no longer receive personal air miles.

The use of air miles for personal gain is currently subject to heated debate among academic experts, many of whom argue that air miles should be used for the benefit of the company rather than the individual employee. They consider that using the benefit for personal use can be considered as fraud (misuse of company assets) and may give rise to personal tax claims against individuals and companies where the use can be considered as a benefit-in-kind.

The academics referred to a recent survey that recommended company codes of ethics and conduct should have specific rules for use of non-cash benefits ("perks") in order to avoid confusion. The survey also noted that a significant proportion of company shareholders were concerned about "abuse" of the scheme by those employees who frequently flew or stayed in hotels on company business. It was not uncommon for directors and senior employees who were able to select particular airlines and hotels, to do so based on their frequent-flyer rewards rather than the lower cost to Fling Exports.

However, many employees (especially those in junior positions) interviewed during the survey voiced the opinion that personal use of air miles was a minor compensation for the inconvenience, discomfort, jet-lagged tiredness and loss of time with family. A reputable psychologist was also quoted as saying "If employers and managers treated employees properly and valued them by rewarding and praising, we would get fewer people maximising their perks".

Environmental groups also argue that air miles encourage cheap travel, which results in an increased carbon footprint, air pollution, noise and ecological damage. They call for the total abolition of air miles.

Required:

(a) **Explain THREE potential risks associated with Fling Export's current approach to the use of air miles.** (6 marks)

(b) **Compare and contrast the current air miles approach with the corporate scheme proposed.** (6 marks)

(c) **Discuss the air miles incentive as a potential principal-agent problem.** (4 marks)

(d) **Using Tucker's 5 question model, evaluate the corporate air miles scheme.** (9 marks)

(25 marks)

3 The owner of Global Assets, Geiorge Ghanzi, has come under investigation by a government regulatory authority for operating a "Ponzi" scheme in which money from new investors is used to repay older investors (when their investment matures) and for paying annual interest. The fraudulent operation is estimated to have cost investors $50 billion in stolen money over the life of its operation. Ten thousand individual investors and a number of major international financial institutions, who had full confidence in the nation's leading investor protection agencies, had fallen victim to the fraud which had gone unnoticed for at least 10 years. The two main financial regulatory authorities over Global Assets have gone on record as "being totally amazed, as well as dismayed" at the size of the fraud.

Both groups of investors protested about the failure of the regulators to fully examine Global Assets' operations over the years (despite doubts raised by some financial commentators) but at the same time admitted that "the investment looked very credible". The banks involved were particularly ferocious in their criticism of the regulators as they claimed to have relied on the regulators' and auditor's annual reports on Global Assets. It later emerged that one bank, which did not invest in Global Assets, had not done so because their due diligence could not reverse engineer the returns Geiorge Ghanzi claimed he was making. The bank concerned did not report their suspicions to the regulatory authorities as they claimed that client confidentiality prevented them from doing so.

It has also emerged that Geiorge Ghanzi was working as an unpaid advisor to one of the market regulators; he was a well-respected former chairman of the technologies stock exchange. Further, his nephew, Antoni Atonias, was working as a member of the senior internal compliance team at the other main regulator. Antoni had taken advantage of that regulator's poor internal procedures for dealing with complaints about investment companies to ensure that any complaints about Global Assets were quickly and quietly dealt with without investigation. He was able to easily mislead the external auditors of Global Assets every time he met with them to discuss the regulatory approach to the company – this included "resolving" any matters they were not sure about from having visited the other main regulator. They had come to trust his expertise. Antoni considered the auditors to be "out of their depth" and easy to mislead.

Legislators are debating whether this scandal together with the broader fallout in the financial system requires new banking legislation and regulations on corporate social responsibility. Some experts argue that the problem has not been an absence of banking regulations but an absence of intelligent supervision. They also suggested that whatever position is taken on corporate social responsibility, if everybody acted morally and ethically there would be no need for regulations.

Others argued that the regulators applied a "light touch" approach as the scheme operated by Global Assets was designed for high-net-worth individuals who could afford to take risks and apply appropriate due diligence – they should have been fully aware of what they were doing and the risks involved.

Required:

(a) **Describe FIVE factors that allowed the fraud by Global Assets to operate for so long without detection.** (5 marks)

(b) **Describe Gray, Owens and Adams' seven positions on social responsibility and explain the most likely position of Geiorge Ghanzi.** (14 marks)

(c) **Explain THREE ethical threats arising from the regulators' failures and an appropriate safeguard that should have been applied.** (6 marks)

(25 marks)

4 The board of GTY Products, an unlisted company, has met to discuss the need to publish sustainability information in a similar fashion to many listed companies as the first step to producing an Integrated Report, again in keeping with the best practice of listed companies.

Gary Moore, the finance director, is of the opinion that such information is not necessary. He feels that as the firm is not listed, the publication of CSR information and Integrated Reporting is irrelevant. Susie Border, the production director, is enthusiastic and says that it would enable potential investors (e.g. banks), customers and suppliers to see the company's "green credentials" if the information was published. She was also enthusiastic that the company should "lead the way for unlisted companies" in producing an Integrated Report. Olga Lewis, the HR Director, asked exactly what the issues were. She said she was aware of the terms "environmental footprint" and "social footprint", but did not really understand the issues involved.

David Smith, the CEO, said that as a former internal auditor, he was certain that appropriate systems could be established to provide the necessary information to be disclosed. Such information could be used for the necessary performance indicators to be published. He also said that he wanted the external auditors to provide an assurance report on the sustainability report. Gary said that the cost of using the external auditors would be far greater than any derived benefit. Olga suggested that the auditors could perform the necessary work as part of their external audit.

Required:

(a) **Define the terms "environmental footprint" and "social footprint" and explain the issues both need to consider and report on.** (12 marks)

(b) **Explain the key differences between a statutory audit of financial statements and a social and environmental audit from which, for example, an assurance report could be given on a sustainability report.** (6 marks)

(c) **Describe appropriate performance indicators using, for example, the Global Reporting Initiative, that could be used when considering social performance in the workplace.** (7 marks)

(25 marks)

End of Question Paper