Professional Level – Essentials Module

Professional Accountant

Monday 8 June 2009

Time allowed
Reading and planning: 15 minutes
Writing: 3 hours

This paper is divided into two sections:

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

Section B – TWO questions ONLY to be attempted

Do NOT open this paper until instructed by the supervisor.
During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.
This question paper must not be removed from the examination hall.

Paper P1

ACCA

The Association of Chartered Certified Accountants

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

1 Global-bank is a prominent European bank with branches throughout Europe and investment arms in many locations throughout the world. It is regarded as one of the world's major international banks. Through its network of investment offices throughout the world, fund managers trade in local investment markets and equities. Futures and derivative traders also operate. Its primary listing is in London although it is also listed in most of the other global stock markets including New York, Hong Kong, Frankfurt and Singapore. As with similar banks in its position, Global-bank's structure is complicated and the complexity of its operations makes the strategic management of the company a demanding and highly technical process. Up until the autumn of 2008, investors had a high degree of confidence in the Global-bank board as it had delivered healthy profits for many years.

In the autumn of 2008, it came to light that Jack Mineta, a Global-bank derivatives trader in the large city office in Philos, had made a very large loss dealing in derivatives over a three-month period. It emerged that the losses arose from Mr Mineta's practice of ignoring the company trading rules which placed limits on, and also restricted, the type of financial instruments and derivatives that could be traded.

The loss, estimated to be approximately US$7 billion, was described by one analyst as 'a huge amount of money and enough to threaten the survival of the whole company'. As soon as the loss was uncovered, Mr Mineta was suspended from his job and the police were called in to check for evidence of fraud. The newspapers quickly reported the story, referring to Mr Mineta as a 'rogue trader' and asking how so much money could be lost without the bank's senior management being aware of it. It turned out that Mr Mineta's line manager at the Philos office had ignored the trading rules in the past in pursuit of higher profits through more risky transactions. Mr Mineta had considerably exceeded his trading limit and this had resulted in the huge loss. It later emerged that Mr Mineta had been dealing in unauthorised products which were one of the riskiest forms of derivatives.

At a press conference after Mr Mineta's arrest, Global-bank's chief executive, Mrs Barbara Keefer, said that her first priority would be to ask the Philos office why the normal internal controls had not been effective in monitoring Mr Mineta's activities. It emerged that Mr Mineta had in the past been one of Global-bank's most profitable derivatives traders. Some journalists suggested to Mrs Keefer that the company was happy to ignore normal trading rules when Mr Mineta was making profits because it suited them to do so.

Another derivatives trader in the Philos office, Emma Hubu, spoke to the media informally. She said that Mr Mineta was brilliant and highly motivated but that he often said that he didn't care about the trading rules. Miss Hubu explained that Mr Mineta didn't believe in right and wrong and once told her that 'I'm in this job for what I can get for myself – big risks bring big returns and big bonuses for me.' She also explained that the culture of the Philos office was driven by Mr Mineta's line manager, Juan Evora. She said that Mr Evora knew that Mr Mineta was breaking trading rules but was also very profits driven and kept compliance information from head office so that the nature of Mr Mineta's trading was not uncovered. The compliance information was required by head office but several failures to return the information had not been acted upon by head office. Mr Evora's bonus was directly linked to the size of the Philos office's profits and all of the derivatives traders, including Mr Mineta, were regularly reminded about the importance of taking risks to make big returns. Miss Hubu said that trading rules were not enforced and that head office never got involved in what went on in Philos as long as the annual profits from the Philos derivative traders were at or above expectations.

It emerged that the lack of correct information from Philos and elsewhere meant that Global-bank's annual report statement of internal control effectiveness was not accurate and gave an unduly favourable impression of the company's internal controls. In addition, the company's audit committee had been recently criticised by the external auditors for a lack of thoroughness. Also, the audit committee had recently lost two non-executive members that had not been replaced.

The amount lost by Mr Mineta made it necessary to refinance the Global-bank business and when the board recommended a US$5 billion rights issue, some of the institutional investors demanded an extraordinary general meeting (EGM). Global-bank's largest single shareholder, the Shalala Pension Fund, that held 12% of the shares, was furious about the losses and wanted an explanation from Mrs Keefer on why internal controls were so ineffective. When the Shalala trustees met after the losses had been reported, it was decided to write an urgent letter to Mrs Keefer expressing the trustees' disappointment at her role in the internal control failures at Global-bank. The letter would be signed by Millau Haber, the chairman of the Shalala trustees.

At the EGM, Mrs Keefer made a statement on behalf of the Global-bank board. In it she said that Mineta had been a rogue trader who had wilfully disregarded the company's internal controls and was, in breaking the company's trading rules, criminally responsible for the theft of company assets. She denied that the main Global-bank board had any responsibility for the loss and said that it was a 'genuinely unforeseeable' situation.

(a) Kohlberg's theory of the development of moral reasoning contains three levels, with each level containing two stages or 'planes'. It is a useful framework for understanding the ways in which people think about ethical issues.

Required:

(i) Explain the three levels of Kohlberg's theory. (6 marks)

(ii) Identify the level that Mr Mineta operated at and justify your choice using evidence from the case. (4 marks)

(iii) Identify, with reasons, the stage (or 'plane') of Kohlberg's moral development most appropriate for a professional bank employee such as Mr Mineta as he undertakes his trading duties. (2 marks)

(b) Explain FIVE typical causes of internal control failure and assess the internal control performance of Global-bank in the case scenario. (10 marks)

(c) Analyse the agency relationship that exists between the board of Global-bank and the trustees of the Shalala Pension Fund. (4 marks)

(d) Distinguish between narrow and wide stakeholders and identify three narrow stakeholders in Global-bank (based on Evan & Freeman's definition) from information in the case. Assess the potential impact of the events described on each narrow stakeholder identified. (10 marks)

(e) You have been asked to draft a letter from Millau Haber, chairman of the Shalala trustees, to Mrs Keefer as a result of concerns over the events described in the case. The letter should explain the roles and responsibilities of the chief executive in internal control, and criticise Mrs Keefer's performance in that role. (10 marks)

Professional marks are available in part (e) for the structure, content, style and layout of the letter. (4 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2 In a major policy speech, Government finance minister Mrs Wei Yttria said that the audit and assurance industry's work should always be judged by the effect it has on public confidence in business. She said that it was crucial that professional services such as audit and assurance should always be performed in the public interest and that there should be no material threats to the assurer's independence. Enron and other corporate failures happened, she said, because some accountants didn't understand what it was to act in the public interest. She stressed that it was important that firms should not provide more than one service to individual clients. If a firm audited a client then, she said, it shouldn't provide any other services to that client.

Mr Oggon Mordue, a financial journalist who had worked in audit and assurance for many years, was in the audience. He suggested that the normal advice on threats to independence was wrong. On the contrary in fact, the more services that a professional services firm can provide to a client the better, as it enables the firm to better understand the client and its commercial and accounting needs. Mrs Yttria disagreed, saying that his views were a good example of professional services firms not acting in the public interest.

Mr Mordue said that when he was a partner at a major professional services firm, he got to know his clients very well through the multiple links that his firm had with them. He said that he knew all about their finances from providing audit and assurance services, all about their tax affairs through tax consulting and was always in a good position to provide any other advice as he had acted as a consultant on other matters for many years including advising on mergers, acquisitions, compliance and legal issues. He became very good friends with the directors of client companies, he said. The clients, he explained, also found the relationship very helpful and the accounting firms did well financially out of it.

Another reporter in the audience argued with Mr Mordue. Ivor Nahum said that Mr Mordue represented the 'very worst' of the accounting profession. He said that accounting was a 'biased and value laden' profession that served minority interests, was complicit in environmental degradation and could not serve the public interest as long as it primarily served the interests of unfettered capitalism. He said that the public interest was badly served by accounting, as it did not address poverty, animal rights or other social injustices.

Required:

(a) Explain, using accounting as an example, what 'the public interest' means as used by Mrs Yttria in her speech. (5 marks)

(b) This requirement concerns ethical threats. It is very important for professional accountants to be aware of ethical threats and to avoid these where possible.

Required:

(i) With reference to the case as appropriate, describe five types of ethical threat. (5 marks)

(ii) Assess the ethical threats implied by Mr Mordue's beliefs. (8 marks)

(c) Assess Ivor Nahum's remarks about the accounting profession in the light of Gray, Owen & Adams' deep green (or deep ecologist) position on social responsibility. (7 marks)

(25 marks)

3 TQ Company, a listed company, recently went into administration (it had become insolvent and was being managed by a firm of insolvency practitioners). A group of shareholders expressed the belief that it was the chairman, Miss Heike Hoiku, who was primarily to blame. Although the company's management had made a number of strategic errors that brought about the company failure, the shareholders blamed the chairman for failing to hold senior management to account. In particular, they were angry that Miss Hoiku had not challenged chief executive Rupert Smith who was regarded by some as arrogant and domineering. Some said that Miss Hoiku was scared of Mr Smith.

Some shareholders wrote a letter to Miss Hoiku last year demanding that she hold Mr Smith to account for a number of previous strategic errors. They also asked her to explain why she had not warned of the strategic problems in her chairman's statement in the annual report earlier in the year. In particular, they asked if she could remove Mr Smith from office for incompetence. Miss Hoiku replied saying that whilst she understood their concerns, it was difficult to remove a serving chief executive from office.

Some of the shareholders believed that Mr Smith may have performed better in his role had his reward package been better designed in the first place. There was previously a remuneration committee at TQ but when two of its four non-executive members left the company, they were not replaced and so the committee effectively collapsed. Mr Smith was then able to propose his own remuneration package and Miss Hoiku did not feel able to refuse him. He massively increased the proportion of the package that was basic salary and also awarded himself a new and much more expensive company car. Some shareholders regarded the car as 'excessively' expensive. In addition, suspecting that the company's performance might deteriorate this year, he exercised all of his share options last year and immediately sold all of his shares in TQ Company.

It was noted that Mr Smith spent long periods of time travelling away on company business whilst less experienced directors struggled with implementing strategy at the company headquarters. This meant that operational procedures were often uncoordinated and this was one of the causes of the eventual strategic failure.

(a) Miss Hoiku stated that it was difficult to remove a serving chief executive from office.

Required:

(i) Explain the ways in which a company director can leave the service of a board. (4 marks)

(ii) Discuss Miss Hoiku's statement that it is difficult to remove a serving chief executive from a board. (4 marks)

(b) Assess, in the context of the case, the importance of the chairman's statement to shareholders in TQ Company's annual report. (5 marks)

(c) Criticise the structure of the reward package that Mr Smith awarded himself. (4 marks)

(d) Criticise Miss Hoiku's performance as chairman of TQ Company. (8 marks)

(25 marks)

4 John Pentanol was appointed as risk manager at H&Z Company a year ago and he decided that his first task was to examine the risks that faced the company. He concluded that the company faced three major risks, which he assessed by examining the impact that would occur if the risk were to materialise. He assessed Risk 1 as being of low potential impact as even if it materialised it would have little effect on the company's strategy. Risk 2 was assessed as being of medium potential impact whilst a third risk, Risk 3, was assessed as being of very high potential impact.

When John realised the potential impact of Risk 3 materialising, he issued urgent advice to the board to withdraw from the activity that gave rise to Risk 3 being incurred. In the advice he said that the impact of Risk 3 was potentially enormous and it would be irresponsible for H&Z to continue to bear that risk.

The company commercial director, Jane Xylene, said that John Pentanol and his job at H&Z were unnecessary and that risk management was 'very expensive for the benefits achieved'. She said that all risk managers do is to tell people what can't be done and that they are pessimists by nature. She said she wanted to see entrepreneurial risk takers in H&Z and not risk managers who, she believed, tended to discourage enterprise.

John replied that it was his job to eliminate all of the highest risks at H&Z Company. He said that all risk was bad and needed to be eliminated if possible. If it couldn't be eliminated, he said that it should be minimised.

(a) The risk manager has an important role to play in an organisation's risk management.

Required:

(i) Describe the roles of a risk manager. (4 marks)

(ii) Assess John Pentanol's understanding of his role. (4 marks)

(b) With reference to a risk assessment framework as appropriate, criticise John's advice that H&Z should withdraw from the activity that incurs Risk 3. (6 marks)

(c) Jane Xylene expressed a particular view about the value of risk management in H&Z Company. She also said that she wanted to see 'entrepreneurial risk takers'.

Required:

(i) Define 'entrepreneurial risk' and explain why it is important to accept entrepreneurial risk in business organisations; (4 marks)

(ii) Critically evaluate Jane Xylene's view of risk management. (7 marks)

(25 marks)

End of Question Paper