

Professional Level – Essentials Module

# Professional Accountant

Monday 14 June 2010

**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.**

The Association of Chartered Certified Accountants

# Paper 1

The ACCA logo consists of the letters 'ACCA' in a bold, white, sans-serif font, centered within a solid black square.

**ACCA**

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

1 Heskett Nuclear (HN) is a nuclear power station in Ayland, a large European country. The HN plant is operated by Heskett Power Company (HPC), which in turn is wholly owned by the government of Ayland. Initially opened in the late 1950s, the power station grew in subsequent decades by the addition of several other facilities on the same site. HN now has the ability to generate 5% of Ayland's entire electricity demand and is one of the largest nuclear stations in Europe. At each stage of its development from the 1950s to the present day, development on the site was welcomed by the relevant local government authorities, by the businesses that have supported it, by the trade union that represents the majority of employees (called Forward Together or FT for short) and also by the national Ayland government. A nuclear reprocessing facility was added in the 1980s. This is a valuable source of overseas income as nuclear power producers in many other parts of the world send material by sea to HN to be reprocessed. This includes nuclear producers in several developing countries that rely on the cheaper reprocessed fuel (compared to 'virgin' fuel) that HN produces.

HPC is loss-making and receives a substantial subsidy each year from the government of Ayland. HPC has proven itself uneconomic but is deemed politically and environmentally necessary as far as the government is concerned. The government of Ayland has reluctantly accepted that large subsidies to HPC will be necessary for many years but considers nuclear power to be a vital component of its energy portfolio (along with other energy sources such as oil, gas, coal, renewables and hydroelectric) and also as a key part of its 'clean' energy strategy. Unlike energy from fossil fuels (such as coal, gas and oil), nuclear power generates a negligible amount of polluting greenhouse gas. HN also provides much needed employment in an otherwise deprived part of the country. The HN power station underpins and dominates the economy of its local area and local government authorities say that the HN plant is vital to the regional economy.

Since it opened, however, the HN power station has been controversial. Whilst being welcomed by those who benefit from it in terms of jobs, trade, reprocessing capacity and energy, a coalition has gradually built up against it comprising those sceptical about the safety and environmental impact of nuclear power. Some neighbouring countries believe themselves to be vulnerable to radioactive contamination from the HN plant. In particular, two countries, both of whom say their concerns about HN arise because of their geographical positions, are vocal opponents. They say that their geographical proximity forced them to be concerned as they are affected by the location of the HN plant which was not of their choosing.

The government of Beeland, whose capital city is 70 km across the sea from HN (which is situated on the coast), has consistently opposed HN and has frequently asked the government of Ayland to close HN down. The Beeland government claims that not only does 'low-level' emission from the site already contaminate the waters separating the two countries but it also claims that any future major nuclear 'incident' would have serious implications for the citizens of Beeland. There is some scientific support for this view although opinion is divided over whether Beeland is being irrational in its general opposition to HN.

The government of Ceeland is also a vocal opponent of HN. Ceeland is located to the north of Beeland and approximately 500 km away from Ayland. Some nuclear scientists have said that with such a large stretch of water between the HN plant and Ceeland, even a much-feared incident would be unlikely to seriously impact on Ceeland. Some commentators have gone further and said that Ceeland's concerns are unfounded and 'borne of ignorance'. FT, the trade union for HN employees, issued a statement saying that Ceeland had no reason to fear HN and that its fears were 'entirely groundless'.

HN's other vocal and persistent opponent is No Nuclear Now (NNN), a well-organised and well-funded campaigning group. Describing itself on its website as 'passionate about the environment', it describes HN's social and environmental footprint as 'very negative'. NNN has often pointed to an environmentally important colony of rare seals living near the HN plant. It says that the seals are dependent on a local natural ecosystem around the plant and are unable to move, arguing that the animals are at significant risk from low-level contamination and would have 'no chance' of survival if a more serious radioactive leak ever occurred. NNN points to such a leak that occurred in the 1970s, saying that such a leak proves that HN has a poor safety record and that a leak could easily recur.

Each time an objection to the HN power station is raised, FT, the trade union, robustly defends the HN site in the media, and argues for further investment, based on the need to protect the jobs at the site. Furthermore, the radiation leak in the 1970s led to FT uniting with the HPC board to argue against those stakeholders that wanted to use the leak as a reason to close the HN site. The combination of union and HPC management was able to counter the arguments of those asking for closure.

HN places a great deal of emphasis on its risk management and often publicises the fact that it conducts continual risk assessments and is in full compliance with all relevant regulatory frameworks. Similarly, FT recently pointed out that HN has had an 'impeccable' safety record since the incident in the 1970s and says on its website that it is 'proud' that its members are involved in ensuring that the company is continually in full compliance with all of the regulatory requirements placed upon it.

The board of HPC, led by chairman Paul Gog, is under continual pressure from the government of Ayland to minimise the amount of government subsidy. Each year, the government places challenging targets on the HPC board requiring stringent cost controls at the HN power station. In seeking to reduce maintenance costs on the expiry of a prior maintenance contract last year, the board awarded the new contract to an overseas company that brought its own workers in from abroad rather than employing local people. The previous contract company was outraged to have lost the contract and the move also triggered an angry response from the local workforce and from FT, the representative trade union.

FT said that it was deplorable that HPC had awarded the contract to an overseas company when a domestic company in Ayland could have been awarded the work. The union convenor, Kate Allujah, said that especially in the nuclear industry where safety was so important, domestic workers were 'more reliable' than foreign workers who were brought in purely on the basis of cost and in whose countries safety standards in similar industries might not be so stringent. HPC said that it had done nothing illegal as the foreign workers were allowed to work in Ayland under international legal treaties. Furthermore, it argued that pressure by FT to raise wages over recent years had created, with the government's subsidy targets, the cost pressure to re-tender the maintenance contract.

On HN's 50th anniversary last year, NNN published what it called a 'risk assessment' for the HN power station. It said it had calculated the probabilities (P) and impacts (I) of three prominent risks.

Risk of major radioactive leak over the next 10 years: P = 10%, I = 20

Risk of nuclear explosion over the next 50 years: P = 20%, I = 100

Risk of major terrorist attack over next 10 years: P = 10%, I = 80

Impacts were on an arbitrary scale of 1–100 where 100 was defined by NNN as 'total nuclear annihilation of the area and thousands of deaths'.

The governments of Beeland and Ceeland seized upon the report, saying that it proved that HN is a genuine threat to their security and should be immediately closed and decommissioned. HN's risk manager, Keith Wan, vigorously disagreed with this assessment saying that the probabilities and the impacts were 'ridiculous', massively overstated and intended to unnecessarily alarm people. HN's public relations office was also angry about it and said it would issue a rebuttal statement.

**Required:**

- (a) **Distinguish between voluntary and involuntary stakeholders, identifying both types of stakeholders in Heskett Nuclear. Assess the claims of THREE of the involuntary 'affected' stakeholders identified.** (12 marks)
- (b) The trade union, Forward Together, has had a long relationship with HN and represents not only the main workforce but also the employees of the maintenance company replaced by the foreign workers.

**Required:**

**Explain the roles of employee representatives such as trade unions in corporate governance and critically evaluate, from the perspective of HPC's board, the contribution of Forward Together in the governance of HPC.** (10 marks)

- (c) **Explain what an agency relationship is and examine the board of HPC's current agency relationship and objectives. Briefly explain how these would differ if HPC was a company with private shareholders.** (10 marks)

- (d) As a part of HPC's public relations effort, it has been proposed that a response statement should be prepared for the company's website to help address two major challenges to their reputation.

**Required:**

**Draft this statement to include the following:**

- (i) Referring to the NNN report, explain why accurate risk assessment is necessary at Heskett Nuclear. (8 marks)
- (ii) Explain what a social and environmental 'footprint' is and construct the argument that HN's overall social and environmental footprint is positive. (6 marks)

Professional marks will additionally be awarded in part (d) for drafting a statement that is clear, has a logical flow, is persuasive and is appropriately structured. (4 marks)

**(50 marks)**

## Section B – TWO questions ONLY to be attempted

- 2 Five years ago, George Woof was appointed chief executive officer (CEO) of Tomato Bank, one of the largest global banks. Mr Woof had a successful track record in senior management in America and his appointment was considered very fortunate for the company. Analysts rated him as one of the world's best bankers and the other directors of Tomato Bank looked forward to his appointment and a significant strengthening of the business.

One of the factors needed to secure Mr Woof's services was his reward package. Prior to his acceptance of the position, Tomato Bank's remuneration committee (comprised entirely of non-executives) received a letter from Mr Woof saying that because his track record was so strong, they could be assured of many years of sustained growth under his leadership. In discussions concerning his pension, however, he asked for a generous non-performance related pension settlement to be written into his contract so that it would be payable whenever he decided to leave the company (subject to a minimum term of two years) and regardless of his performance as CEO. Such was the euphoria about his appointment that his request was approved. Furthermore in the hasty manner in which Mr Woof's reward package was agreed, the split of his package between basic and performance-related components was not carefully scrutinised. Everybody on the remuneration committee was so certain that he would bring success to Tomato Bank that the individual details of his reward package were not considered important.

In addition, the remuneration committee received several letters from Tomato Bank's finance director, John Temba, saying, in direct terms, that they should offer Mr Woof 'whatever he wants' to ensure that he joins the company and that the balance of benefits was not important as long as he joined. Two of the non-executive directors on the remuneration committee were former colleagues of Mr Woof and told the finance director they would take his advice and make sure they put a package together that would ensure Mr Woof joined the company.

Once in post, Mr Woof led an excessively aggressive strategy that involved high growth in the loan and mortgage books financed from a range of sources, some of which proved unreliable. In the fifth year of his appointment, the failure of some of the sources of funds upon which the growth of the bank was based led to severe financing difficulties at Tomato Bank. Shareholders voted to replace George Woof as CEO. They said he had been reckless in exposing the company to so much risk in growing the loan book without adequately covering it with reliable sources of funds.

When he left, the press reported that despite his failure in the job, he would be leaving with what the newspapers referred to as an 'obscenely large' pension. Some shareholders were angry and said that Mr Woof was being 'rewarded for failure'. When Mr Woof was asked if he might voluntarily forego some of his pension in recognition of his failure in the job, he refused, saying that he was contractually entitled to it and so would be keeping it all.

### Required:

- (a) **Criticise the performance of Tomato Bank's remuneration committee in agreeing Mr Woof's reward package.** (10 marks)
- (b) **Describe the components of an appropriately designed executive reward package and explain why a more balanced package of benefits should have been used to reward Mr Woof.** (10 marks)
- (c) **Construct an ethical case for Mr Woof to voluntarily accept a reduction in his pension value in recognition of his failure as chief executive of Tomato Bank.** (5 marks)

**(25 marks)**

- 3** The Committee of Sponsoring Organisations (COSO) of the Treadway Commission is an American voluntary, private sector organisation and is unconnected to government or any other regulatory authority. It was established in 1985 to help companies identify the causes of fraudulent reporting and to create internal control environments able to support full and accurate reporting. It is named after its first chairman, James Treadway, and has issued several guidance reports over the years including important reports in 1987, 1992 and 2006.

In 2009, COSO issued new 'Guidance on monitoring internal control systems' to help companies tighten internal controls and thereby enjoy greater internal productivity and produce higher quality reporting. The report, written principally by a leading global professional services firm but adopted by all of the COSO members, noted that 'unmonitored controls tend to deteriorate over time' and encouraged organisations to adopt wide ranging internal controls. It went on to say that, the 'assessment of internal controls [can] ... involve a significant amount of ... internal audit testing.'

After its publication, the business journalist, Mark Rogalski, said that the latest report contained 'yet more guidance from COSO on how to make your company less productive by burdening it even more with non-productive things to do' referring to the internal control guidance the 2009 report contains. He said that there was no industry sector-specific advice and that a 'one-size-fits-all' approach to internal control was 'ridiculous'. He further argued that there was no link between internal controls and external reporting, and that internal controls are unnecessary for effective external reporting.

Another commentator, Claire Mahmood, wrote a reply to Rogalski's column pointing to the views expressed in the 2009 COSO report that, 'over time effective monitoring can lead to organisational efficiencies and reduced costs associated with public reporting on internal control because problems are identified and addressed in a proactive, rather than reactive, manner.' She said that these benefits were not industry sector specific and that Rogalski was incorrect in his dismissal of the report's value. She also said that although primarily concerned with governance in the USA, the best practice guidance from COSO could be applied by companies anywhere in the world. She said that although the USA, where COSO is based, is concerned with the 'rigid rules' of compliance, the advice ought to be followed by companies in countries with principles-based approaches to corporate governance because it was best practice.

**Required:**

- (a) **Distinguish between rules-based and principles-based approaches to internal control system compliance as described by Claire Mahmood and discuss the benefits to an organisation of a principles-based approach.** (7 marks)
- (b) Mr Rogalski is sceptical over the value of internal control and believes that controls must be industry-specific to be effective.

**Required:**

**Describe the advantages of internal control that apply regardless of industry sector and briefly explain the meaning of the statement, 'unmonitored controls tend to deteriorate over time'. Your answer should refer to the case scenario as appropriate.** (10 marks)

- (c) The COSO report explains that 'assessment of internal controls [can] ... involve a significant amount of ... internal audit testing.'

**Required:**

**Define 'internal audit testing' and explain the roles of internal audit in helping ensure the effectiveness of internal control systems.** (8 marks)

**(25 marks)**

- 4 'Happy and healthy' is a traditional independent health food business that has been run as a family company for 40 years by Ken and Steffi Potter. As a couple they have always been passionate campaigners for healthy foods and are more concerned about the quality of the foods they sell than the financial detail of their business. Since the company started in 1970, it has been audited by Watson Shreeves, a local audit firm. Mr Shreeves has overseen the Potters' audit for all of the 40 year history (rotating the engagement partner) and has always taken the opportunity to meet with Ken and Steffi informally at the end of each audit to sign off the financial statements and to offer a briefing and some free financial advice in his role as what he calls, 'auditor and friend'. In these briefings, Mr Shreeves, who has become a close family friend of the Potters over the years, always points out that the business is profitable (which the Potters already knew without knowing the actual figures) and how they might increase their margins. But the Potters have never been too concerned about financial performance as long as they can provide a good service to their customers, make enough to keep the business going and provide continued employment for themselves and their son, Ivan. Whilst Ken and Steffi still retain a majority shareholding in 'Happy and healthy' they have gradually increased Ivan's proportion over the years. They currently own 60% to Ivan's 40%. Ivan was appointed a director, alongside Ken and Steffi, in 2008.

Ivan grew up in the business and has helped his parents out since he was a young boy. As he grew up, Ken and Steffi gave him more and more responsibility in the hope that he would one day take the business over. By the end of 2009, Ken made sure that Ivan drew more salary than Ken and Steffi combined as they sought to ensure that Ivan was happy to continue in the business after they retired.

During the audit for the year ended 31 March 2010, a member of Watson Shreeves was performing the audit as usual when he noticed a dramatic drop in the profitability of the business as a whole. He noticed that whilst food sales continued to be profitable, a large amount of inventory had been sold below cost to Barong Company with no further explanation and it was this that had caused the reduction in the company's operating margin. Each transaction with Barong Company had, the invoices showed, been authorised by Ivan.

Mr Shreeves was certain Ken and Steffi would not know anything about this and he prepared to tell them about it as a part of his annual end of audit meeting. Before the meeting, however, he carried out some checks on Barong Company and found that it was a separate business owned by Ivan and his wife. Mr Shreeves's conclusion was that Ivan was effectively stealing from 'Happy and healthy' to provide inventory for Barong Company at a highly discounted cost price. Although Mr Shreeves now had to recommend certain disclosures to the financial statements in this meeting, his main fear was that Ken and Steffi would be devastated if they found out that Ivan was stealing and that it would have long-term implications for their family relationships and the future of 'Happy and healthy'.

**Required:**

- (a) **Explain how a family (or insider-dominated) business differs from a public listed company and, using evidence from the case, explore the governance issues of a family or insider-dominated business.** (10 marks)
- (b) **Mr Shreeves is a professional accountant and auditor. Explain why he is considered a professional by society and describe the fundamental principles (or responsibilities) of professionalism that society expects from him and all other accountants.** (7 marks)
- (c) **Discuss the professional and ethical dilemma facing Mr Shreeves in deciding whether or not to tell Ken and Steffi about Ivan's activity. Advise Mr Shreeves of the most appropriate course of action.** (8 marks)

**(25 marks)**

**End of Question Paper**