

Professional Level – Essentials Module

# Professional Accountant

Monday 14 December 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.**

The Association of Chartered Certified Accountants

# Paper P1

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

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

- 1 The Mary Jane was a large passenger and vehicle ferry operating between the two major ports of Eastport and Northport across a busy section of ocean known as the 'Northport route'. Prior to this, the Mary Jane had operated for many years in the much calmer waters of the 'Southsea route' but she had been transferred to the Northport route because her large size meant that more profit could be made by carrying more passengers and vehicles per journey. She was capable of carrying up to 1,000 passengers, 300 cars and 100 lorries per trip. The Mary Jane belonged to Sea Ships Company, a long established international company with a fleet of five ships operating on routes in other parts of the world. The Mary Jane had large doors at both the front and rear. Vehicles would drive in through the rear doors in Eastport and when she arrived in Northport, the Mary Jane would dock the other way round so that the vehicles could drive straight out using the forward doors. There were two doors at each end, upper and lower, and it was important that all four doors were securely closed before setting out to sea.

As with all marine operations, the safety procedures aboard the Mary Jane were subject to regulation, but her design left one weakness which was eventually to prove a disaster. From the main control bridge of the ship, it was not possible to see the front or rear doors, which meant that it wasn't possible to check from the main control bridge that they were closed upon departure from a port. On the night of 7 November, the Mary Jane was leaving Eastport in a storm for a crossing to Northport, a journey which should have taken five hours. It was dark and the weather was very poor. When she was only a few kilometres out from the Eastport harbour, water entered the car decks through the upper rear doors that had been left open after the Mary Jane had left port. The stormy conditions meant that the waves were very high and on this occasion, high enough so that when a large wave hit, the water entered through the open rear doors. Once enough water had entered her car decks, the Mary Jane began to lean to 30 degrees before completely falling over onto her side. The speed of the event, less than two minutes, meant that escape via lifeboats wasn't possible and the Mary Jane sank with the loss of many lives.

Among the survivors was first officer Ned Prop. Mr Prop later told how a recent change to staff reporting procedures had produced a situation in which the responsibility for checking that the rear doors were closed before sailing had changed. He said that, under the new system, two people were responsible for safety on the car deck but each person assumed that the other had checked that the upper rear doors had been closed. A reporting system in which each department head (car deck, navigation, etc.) on the ship separately reported readiness for sea to the captain at the beginning of each journey had been abandoned because it was too inconvenient to operate. Mr Prop said that the normal procedure was that if they didn't hear anything to the contrary by the departure time, he and Captain Mullett assumed that all was well throughout the ship and they could put to sea.

Mr Prop told how procedures on board ship often relied on 'human teamwork' rather than 'following paperwork systems'. It also emerged that, on the day of the disaster, a mistake in loading vehicles onto the wrong decks had delayed the ship's departure and created pressure to leave as soon as possible after all the vehicles were loaded. Mr Prop said that this too may have been a contributory factor to the confusion over who should have checked that the rear doors were closed. Mr Prop's superior officer, Captain Mullett, was drowned in the disaster.

Sea Ships Company, the Mary Jane's owner, was one of the longest established and most respected companies listed on the stock exchange. Although best known for its ferry operations, it had diversified into other activities in recent years. It was considered by investment analysts to be a 'steady and reliable' investment and the company chief executive, Wim Bock, had often said that Sea Ships Company employed 'the highest standards of corporate ethics'. It also valued its reputation as a well-run company and believed that the company's value was primarily due to its reputation for 'outstanding customer care'. The board often claimed that Sea Ships was a socially responsible company.

When Sea Ships' board met to discuss how to proceed after the disaster, Wim Bock said that the company could expect to receive substantial claims from victims' relatives. He also reported that, because of a regrettable oversight in the company's legal department, only a proportion of that liability would be covered by the company's insurance. There would also be punitive fines from the courts, the size of which would, a legal advisor said, reflect the scale of Sea Ship's negligence in contributing to the disaster. The finance director, Jill Wha, reported that if the company met the expected uninsured liabilities in full, even if reduced on appeal, it would severely threaten future cash flows as it would most likely have to sell non-current assets (most of its ships) to settle the claims. If large punitive fines were also imposed after the legal process, Mr Bock said that the company may not survive.

The government ordered an enquiry and a senior official was appointed to investigate the disaster. In her conclusions, enquiry chairman Caroline Chan said that in addition to the human error in not ensuring that the upper rear doors

had been closed, it had also emerged that the Mary Jane had been travelling above the local shipping speed limit out of Eastport harbour. The excess speed had caused increased turbulence in the water and this was made much worse by the storm on the night in question. The combination of these factors meant that water gradually entered the open upper rear doors and this eventually caused the ship to lean and then capsize. Mrs Chan said that contrary to the board's perception of itself as a well-run company, she had encountered a 'culture of carelessness' at Sea Ships and that the internal control systems were inadequate for safely operating a fleet of ships. She reserved particular criticism for the board of Sea Ships saying that it was unbalanced, lacked independent scrutiny and, because none of the existing directors had ever served on board a ship, lacked representation from technically qualified nautical officers.

After the enquiry was concluded, but before the level of claims and punitive damages had been set by the courts, a document emerged within the company confirming that certain independent advice had been received from an external consultant. The advice was received at the time of the Mary Jane's transfer from the Southsea route to the Northport route. Because the Northport route is a much rougher area of sea, the advice concerned structural changes to the Mary Jane that would make her safer in rougher seas. Had the advice been followed, the Mary Jane would have had additional doors inserted inside the car deck to act as a second internal bulkhead to prevent water flooding the whole deck. Water would still have entered through the open rear doors on the night of 7 November, but would have been kept sealed in that rear section of the car deck and the Mary Jane would not have sunk. The company had received the advice but had not acted upon it as it would have required an expensive refit for the Mary Jane. This advice was then 'lost' in the company and only emerged later on.

**Required:**

- (a) The independent consultant's advice was that the Mary Jane should have received structural work to make her safe for operating in the rougher seas of the Northport route. Sea Ships Company did not act on the advice.

**Using the seven-step American Accounting Association (AAA) model for ethical decision-making, examine the company's dilemma on whether or not to disclose this information publicly.** (14 marks)

- (b) **Using information from the case, identify and analyse the internal control failures at Sea Ships Company and on the Mary Jane.** (12 marks)

- (c) **Assess the contribution that non-executive directors might have made in improving the corporate governance at Sea Ships Company.** (8 marks)

- (d) **Draft a memo from chief executive Wim Bock to the senior officers on the other ships in the Sea Ships fleet informing them of vital internal control and risk issues following the loss of the Mary Jane. The memo should include the following, all placed in the context of the case.**

(i) **An assessment, based on information in the case, of the importance for the board of Sea Ships to have all the information relating to key operational internal controls and risks;** (6 marks)

(ii) **An explanation of the qualitative characteristics of information needed by the Sea Ships' board for the assessment of internal controls and risks.** (6 marks)

Professional marks will additionally be awarded in part (d) for drafting a memo 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 Sam Mesentery was appointed a director of Ding Company in October this year taking on the role of financial controller. He had moved himself and his family to a new country to take up the post and was looking forward to the new challenges. When he arrived he learned that he was on the 'operating board' of Ding Company and that there was a 'corporate board' above the operating board that was senior to it. This surprised him as in the companies he had worked for in his own country, all directors in the company were equal. The corporate board at Ding was small, with five directors in total, while the operating board was larger, with ten members.

After a few days in the job he received an e-mail requiring him to report to Annette Hora, the managing director. She said that she had regretfully received two complaints from another senior colleague about Sam's behaviour. First, Sam had apparently made a highly inappropriate remark to a young female colleague and second, his office was laid out in the wrong way. Not only was his desk positioned in breach of fire regulations but also, he was told that it was normal to have the desk facing towards the door so that colleagues felt more welcomed when they went in. 'It's company policy' she said abruptly. Sam remembered the conversation with the young female colleague but was unaware of anything inappropriate in what he had said to her. He said that he positioned his desk so he could get the best view out of the window when he was working.

The following day he arrived at work to find that the corporate board was in an emergency meeting. There had been a sudden and dramatic change in the circumstances of one of Ding's major suppliers and the corporate board later said that they needed to meet to agree a way forward and a strategy to cope with the change. Annette said that because of the competitive nature of its resource markets, Ding had to act fast and preferably before its competitors. Hence the necessity of a two-tier board structure. She said there was no time for lengthy discussions which was why the operating board was excluded. Sam was told that Ding operated in a 'complex and turbulent' environment and when strategic factors in the environment changed, the company often had to respond quickly and decisively.

It was a month later that Sam first met with Arif Zaman, Ding's non-executive chairman. After Arif asked Sam how he was settling in, Sam asked Arif why he preferred a two-tier board structure and Arif replied that actually it was Annette's idea. He said that she prefers it that way and because he is a non-executive member doesn't feel able to challenge her opinion on it. Because 'it seems to work' he had no plans to discuss it with her. He went on to say that he was an old friend of Annette's and was only in post to satisfy the corporate governance requirements to have a non-executive chairman. He said that he saw his role as mainly ceremonial and saw no need to take any direct interest in the company's activities. He said that he chaired some board meetings when he was available and he sometimes wrote the chairman's statement in the annual report.

### Required:

- (a) Explain the content of a director's induction programme and assess the advantages of such a programme for Sam. (8 marks)
- (b) Using information from the case, critically evaluate Annette's belief that two-tier boards are preferable in complex and turbulent environments such as at Ding Company. (8 marks)
- (c) Assess Arif Zaman's understanding of his role as non-executive chairman. (9 marks)

**(25 marks)**

**3** John Wang is a junior partner and training manager at Miller Dundas, a medium sized firm of auditors. He oversees the progress of the firm's student accountants. One of those under John's supervision, Lisa Xu, recently wrote in her progress and achievement log about a situation in an audit that had disturbed her.

On the recent audit of Mbabo Company, a medium sized, family-run business and longstanding client of Miller Dundas, Lisa was checking non-current asset purchases when she noticed what she thought might be an irregularity. There was an entry of \$100,000 for a security system for an address in a well-known holiday resort with no obvious link to the company. On questioning this with Ellen Tan, the financial controller, Lisa was told that the system was for Mr Martin Mbabo's holiday cottage (Martin Mbabo is managing director and a minority shareholder in the Mbabo Company). She was told that Martin Mbabo often took confidential company documents with him to his holiday home and so needed the security system on the property to protect them. It was because of this, Ellen said, that it was reasonable to charge the security system to the company.

Ellen Tan expressed surprise at Lisa's concerns and said that auditors had not previously been concerned about the company being charged for non-current assets and operational expenses for Mr Mbabo's personal properties.

Lisa told the engagement partner, Potto Sinter, what she had found and Potto simply said that the charge could probably be ignored. He did agree, however, to ask for a formal explanation from Martin Mbabo before he signed off the audit. Lisa wasn't at the final clearance meeting but later read the following in the notes from the clearance meeting: 'discussed other matter with client, happy with explanation'. When Lisa discussed the matter with Potto afterwards she was told that the matter was now closed and that she should concentrate on her next audit and her important accounting studies.

When John Wang read about Lisa's concerns and spoke to her directly, he realised he was in an ethical dilemma. Not only should there be a disclosure requirement of Mr Mbabo's transaction, but the situation was made more complicated by the fact that Potto Sinter was senior to John Wang in Miller Dundas and also by the fact that the two men were good friends.

**Required:**

**(a) Explain the meaning of 'integrity' and its importance in professional relationships such as those described in the case.** (5 marks)

**(b) Criticise Potto Sinter's ethical and professional behaviour in the case.** (10 marks)

**(c) Critically evaluate the alternatives that John Wang has in his ethical dilemma.** (10 marks)

**(25 marks)**

- 4 After a major fire had destroyed an office block belonging to Saltoc Company, the fire assessment reported that the most likely cause was an electrical problem. It emerged that the electrical system had suffered from a lack of maintenance in recent years due to cost pressures. Meanwhile in the same week, it was reported that a laptop computer containing confidential details of all of Saltoc's customers was stolen from the front seat of a car belonging to one of the company's information technology (IT) mid-managers. This caused outrage and distress to many of the affected customers as the information on the laptop included their bank details and credit card numbers. Some customers wrote to the company to say that they would be withdrawing their business from Saltoc as a result.

When the board met to review and consider the two incidents, it was agreed that the company had been lax in its risk management in the past and that systems should be tightened. However, the financial director, Peter Osbida, said that he knew perfectly well where systems should be tightened. He said that the fire was due to the incompetence of Harry Ho the operations manager and that the stolen laptop was because of a lack of security in the IT department led by Laura Hertz. Peter said that both colleagues were 'useless' and should be sacked. Neither Harry nor Laura liked or trusted Peter and they felt that in disputes, chief executive Ken Tonno usually took Peter's side.

Both Harry and Laura said that their departments had come under severe pressure because of the tight cost budgets imposed by Peter. Ken Tonno said that the last few years had been 'terrible' for Saltoc Company and that it was difficult enough keeping cash flows high enough to pay the wage bill without having to worry about 'even more' administration on risks and controls. Peter said that Harry and Laura both suffered in their roles by not having the respect of their subordinates and pointed to the high staff turnover in both of their departments as evidence of this.

Mr Tonno asked whether having a complete risk audit (or risk review) might be a good idea. He shared some of Peter's concerns about the management skills of both Harry and Laura, and so proposed that perhaps an external person should perform the risk audit and that would be preferable to one conducted by a colleague from within the company.

**Required:**

- (a) Describe what 'embedding' risk means with reference to Saltoc Company. (6 marks)
- (b) Assess the ability of Saltoc's management culture to implement embedded risk systems. (8 marks)
- (c) Explain what external risk auditing contains and construct the case for an external risk audit at Saltoc Company. (11 marks)

**(25 marks)**

**End of Question Paper**