Answers

1 (a) (i) Institutional investor intervention

Six reasons are typically cited as potential grounds for investor intervention. Whilst it would be rare to act on the basis of one factor (unless it was particularly unfavourable), an accumulation of factors may have such an effect. Furthermore, institutional investors have a moral duty to use their power to monitor the companies they invest in for the good of all investors, as recognised in most codes of corporate governance. Institutional investors have the expertise at their disposal to understand the complexities of managing large corporations. As such, they can take a slightly detached view of the business and offer advice where appropriate. The typical reasons for intervention are cited below.

Concerns about strategy, especially when, in terms of long-term investor value, the strategy is likely to be excessively risky or, conversely, unambitious in terms of return on investment. The strategy determines the long-term value of an investment and so is very important to shareholders.

Poor or *deteriorating performance*, usually over a period of time, although a severe deterioration over a shorter period might also trigger intervention, especially if the reasons for the poor performance have not been adequately explained in the company's reporting.

Poor non-executive performance. It is particularly concerning when non-executives do not, for whatever reason, balance the executive board and provide the input necessary to reassure markets. Their contributions should always be seen to be effective. This is especially important when investors feel that the executive board needs to be carefully monitored or constrained, perhaps because one or another of the factors mentioned in this answer has become an issue.

Major *internal control failures*. These are a clear sign of the loss of control by senior management over the operation of the business. These might refer, for example, to health and safety, quality, budgetary control or IT projects. In the case of ZPT, there were clear issues over the control of IC systems for generating financial reporting data.

Compliance failures, especially with statutory regulations or corporate governance codes. Legal non-compliance is always a serious matter and under comply-or-explain, all matters of code non-compliance must also be explained. Such explanations may or may not be acceptable to shareholders.

Excessive directors' remuneration or defective remuneration policy. Often an indicator of executive greed, excessive board salaries are also likely to be an indicator of an ineffective remunerations committee which is usually a non-executive issue. Whilst the absolute monetary value of executive rewards are important, it is usually more important to ensure that they are highly aligned with shareholder interests (to minimise agency costs).

Poor CSR or *ethical performance*, or lack of social responsibility. Showing a lack of CSR can be important in terms of the company's long-term reputation and also its vulnerability to certain social and environmental risks.

[Tutorial note: the study texts approach this slightly differently.]

(ii) Case for intervention

After the first restatement, it was evident that three of the reasons for interventions were already present. Whilst one of these perhaps need not have triggered an intervention alone, the number of factors makes a strong case for an urgent meeting between the major investors and the ZPT board, especially Mr Xu.

Poor performance. The restated results were 'all significantly below market expectations'. Whilst this need not in itself have triggered an institutional investor intervention, the fact that the real results were only made public after an initial results announcement is unfortunate. The obvious question to ask the ZPT board is why the initial results were mis-stated and why they had to be corrected as this points to a complete lack of controls within the business. A set of results well below market expectations always needs to be explained to shareholders.

Internal control and potential compliance failures. There is ample evidence to suggest that internal controls in ZPT were very deficient, especially (and crucially) those internal controls over external financial reporting. The case mentions, 'no effective management oversight of the external reporting process and a disregard of the relevant accounting standards', both of which are very serious allegations. Linked to this, the investors need an urgent clarification of the legal allegations of fraud, especially in the light of the downward restatement of the results. Any suggestion of compliance failure is concerning but fraud (down to intent rather than incompetence) is always serious as far as investors are concerned.

Excessive remuneration in the form of the $20 million bonus. It is likely that this bonus was excessive even had the initial results been accurate, but after the restatement, the scale of the bonus was evidently indefensible as it was based on false figures. The fact that the chief executive is refusing to repay the bonus implies a lack of integrity, adding weight to the belief that there may be some underlying dishonesty. Furthermore, although the investors thought it excessive, the case describes this as within the terms of Mr Xu's contract. A closer scrutiny of remunerations policy (and therefore non-executive effectiveness) would be appropriate.

(b) Absolutist and relativist perspectives

Absolutism and relativism

An absolutist ethical stance is when it is assumed that there is an unchanging set of ethical principles which should always be obeyed regardless of the situation or any other pressures or factors that may be present. Typically described in universalist ways, absolutist ethics tends to be expressed in terms such as 'it is always right to . . .', 'it is never right to . . .' or 'it is always wrong to . . .'

Relativist ethical assumptions are those that assume that real ethical situations are more complicated than absolutists allow for. It is the view that there are a variety of acceptable ethical beliefs and practices and that the right and most appropriate belief depends on the situation. The best outcome is arrived at by examining the situation and making ethical assessments based on the best outcomes in that situation.

Evaluation of Shazia Lo's behaviour – absolutist ethics
Firstly, Shazia Lo was correct to be concerned about the over-valuation of contracts at ZPT. As a qualified accountant, she should never be complicit in the knowing mis-statement of accounts or the misrepresentation of contract values. For a qualified accountant bound by very high ethical and professional standards, she was right to be absolutist in her instincts even if not in her eventual behaviour.

Secondly, she was also right to raise the issue with the finance director. This was her only legitimate course of action in the first instance and it would have been wrong, in an absolutist sense, to remain silent. Given that she was intimidated and threatened upon raising the issue, she was being absolutist in threatening to take the issue to the press (i.e. whistleblowing). It would be incompatible with her status as a professional accountant to be complicit in false accounting as she owed it to the ZPT shareholders, to her professional body and to the general public (the public interest) never to process accounting data she knows to be inaccurate. An effective internal audit process would be a source of information for this action.

Evaluation of Shazia Lo's behaviour – relativist ethics
It is clear from Shazia Lo's behaviour that despite having absolutist instincts, other factors caused her to assume a relativist ethic in practice.

Her mother's serious illness was evidently the major factor in overriding her absolutist principles with regard to complicity in the fraudulent accounting figures. It is likely she weighed her mother's painful suffering against the need to be absolutist with regard to the mis-statement of contract values. In relativist situations, it is usually the case that *one 'good' is weighed against another 'good'*. Clearly it is good (an absolute) to show compassion and sympathy toward her mother but this *should not have caused her to accept the payment* (effectively a bribe to keep silent). She may have *reasoned that the continued suffering of her mother was a worse ethical outcome than the mis-statement of ZPT accounts* and the fact that she received no personal income from the money (it all went to support her mother) would suggest that she acted with reasonable motives even though her decision as a professional accountant was definitely inappropriate. Given that accepting bribes is a clear breach of professional codes of ethics for accountants and other professionals, there is no legitimate defence of her decision and her behaviour was therefore wrong.

(c) (i) Speech on importance of good corporate governance and consequences of failure

Introduction
Ladies and Gentlemen, I begin my remarks today by noting that we meet at an unfortunate time for business in this country. In the wake of the catastrophic collapse of ZPT, one of the largest telecommunications companies, we have also had to suffer the loss of one of our larger audit firms, JJC. This series of events has heightened in all of us an awareness of the vulnerability of business organisations to management incompetence and corruption.

The consequences of corporate governance failures at ZPT.
I would therefore like to remind you all why corporate governance is important and I will do this by referring to the failures in this unfortunate case. Corporate governance failures affect many groups and individuals and as legislators, we owe it to all of them to ensure that the highest standards of corporate governance are observed.

Firstly and probably most obviously, effective corporate governance *protects the value of shareholders' investment in a company*. We should not forget that the majority of shareholders are not 'fat cats' who may be able to afford large losses. Rather, they are individual pension fund members, small investors and members of mutual funds. The hard-working voters who save for the future have their efforts undermined by selfish and arrogant executives who deplete the value of those investments. This unfairness is allowed to happen because of a lack of regulation of corporate governance in this country.

The second group of people to lose out after the collapse of ZPT were *the employees*. It is no fault of theirs that their directors were so misguided and yet it is they who bear a great deal of the cost. I should stress, of course, that jobs were lost at JJC as well as at ZPT. Unemployment, even when temporary and frictional, is a personal misery for the families affected and it can also increase costs to the taxpayer when state benefits are considered.

Thirdly, because of the collapse of ZPT, *creditors have gone unpaid and customers have remained unserviced*. Again, we should not assume that suppliers can afford to lose their receivables in ZPT and for many smaller suppliers, their exposure to ZPT could well threaten their own survival. Where the value of net assets is inadequate to repay the full value of payables, let alone share capital, there has been a failure in company direction and in corporate governance so I hope you will agree with me that effective management and sound corporate governance are vital.

The loss of two such important businesses, ZPT and JJC, has *caused great disturbance in the telecommunications and audit industries*. As JJC lost its legitimacy to provide audit services and its clients moved to other auditors, the structure of the industry changed. Other auditors will eventually be able to absorb the work previously undertaken by JJC but clearly this will cause short-to-medium term capacity issues for those firms as they redeploy resources to make good on those new contracts. This was, I should remind you, both unnecessary and entirely avoidable.

Linked to this point, I would remind colleagues that it is important for *business in general and auditing in particular to be respected in society.* The *loss of auditors' reputation* caused by these events is very unfortunate as *auditing underpins* *our collective confidence in business reporting*. It would be wholly inappropriate for other auditors to be affected by the behaviour of JJC or for businesses in general to be less trusted because of the events at ZPT. I very much hope that such losses of reputation and in public confidence will not occur.

Finally, we have all been dismayed by the case of Shazia Lo that was reported in the press. A lack of sound corporate governance practice *places employees such as Ms Lo in impossible positions*. Were she to act as whistleblower she would, by all accounts, have been victimised by her employers. Her acceptance of what was effectively a bribe to remain silent brings shame both on Ms Lo and on those who offered the money. An effective audit committee at ZPT would have offered a potential outlet for Ms Lo's concerns and also provided a means of reviewing external audit and other professional services at ZPT. This whole situation could, and would have been, avoided had the directors of ZPT managed the company under an effective framework of corporate governance.

(ii) The case for the mandatory external reporting of internal controls and risks

I now turn to the issue of the mandatory external reporting of internal controls and risks. My reason for raising this as an issue is because this was one of the key causes of ZPT's failure.

My first point in this regard is that *disclosure allows for accountability*. Had investors been aware of the internal control failures and business probity risks earlier, it may have been possible to replace the existing board before events deteriorated to the extent that they sadly did. In addition, however, the need to generate a report on internal controls annually will *bring very welcome increased scrutiny from shareholders* and others. It is only when things are made more transparent that effective scrutiny is possible.

Secondly, I am firmly of the belief that more information on internal controls would *enhance shareholder confidence and satisfaction*. It is vital that investors have confidence in the internal controls of companies they invest in and increased knowledge will encourage this. It was, I would remind you, *a lack of confidence in ZPT's internal controls* and the strong suspicion of fraud that caused the share price to collapse and the company to ultimately fail.

Furthermore, compulsory external reporting on internal controls will *encourage good practice inside the company*. The knowledge that their work will be externally reported upon and scrutinised by investors will *encourage greater rigour in the IC function* and in the audit committee. This will further increase investor confidence.

To those who might suggest that we should opt for a comply-or-explain approach to this issue, I would argue that this is simply *too important an issue to allow companies to decide for themselves* or to interpret non-mandatory guidelines. It must be legislated for because otherwise *those with poor internal controls will be able to avoid reporting* on them. By specifying what should be disclosed on an annual basis, companies will need to make the audit of internal controls an integral and ongoing part of their operations. It is to the contents of an internal control report that I now turn.

(iii) Content of external report on internal controls

I am unable, in a speech such as this, to go into the detail of what I would like to see in an external report on internal controls, but in common with corporate governance codes elsewhere, there are four broad themes that such a report should contain.

Firstly, the report should contain *a statement of acknowledgement by the board* that it is responsible for the company's system of internal control and for reviewing its effectiveness. This might seem obvious but it has been shown to be an important starting point in *recognising responsibility*. It is only when the board accepts and acknowledges this responsibility that the impetus for the collection of data and the authority for changing internal systems is provided. The 'tone from the top' is very important in the development of my proposed reporting changes and so this is a very necessary component of the report.

Secondly, the report should summarise the *processes the board (or where applicable, through its committees) has applied* in reviewing the effectiveness of the system of internal control. These may or may not satisfy shareholders, of course, and weak systems and processes would be a matter of discussion at AGMs for non-executives to strengthen.

Thirdly, the report should *provide meaningful, high level information* that does not give a misleading impression. Clearly, internal auditing would greatly increase the reliability of this information but a robust and effective audit committee would also be very helpful.

Finally, the report should contain *information about any weaknesses in internal control* that have resulted in error or material losses. This would have been a highly material disclosure in the case of ZPT and the costs of non-disclosure of this was a major cause of the eventual collapse of the company

I very much hope that these brief remarks have been helpful in persuading colleagues to consider the need for increased corporate governance legislation. Thank you for listening.

[Tutorial note: full speech not required to gain full professional marks as the question asks for 'sections' of the speech.]

2 (a) Explain 'sustainability' and criticise the finance director's understanding of sustainability

Sustainability is the ability of the business to continue to exist and conduct operations *with no effects on the environment that cannot be offset or made good in some other way.* The best working definition is that given by the Gro Harlem Brundtland, the former Norwegian prime minister in the Brundtland Report (1987) as activity that, *'meets the needs of the present without compromising the ability of future generations to meet their own needs.'* Importantly, it refers to both the *inputs and outputs* of any organisational process. *Inputs (resources) must only be consumed at a rate* at which they can be reproduced, offset or in some other way not irreplaceably depleted. *Outputs (such as waste and products) must not pollute* the environment at a rate greater than can be cleared or offset. Recycling is one way to reduce the net impact of product impact on the environment. The business activities must take into consideration the carbon emissions, other pollution to water, air and local environment, and should use strategies to neutralise these impacts by engaging in environmental practices that will replenish the used resources and eliminate harmful effects of pollution. A number of reporting frameworks have been developed to help in accounting for sustainability including the notion of triple-bottom-line accounting and the Global Reporting Initiative (GRI). Both of these attempt to measure the social and environmental impacts of a business in addition to its normal accounting.

The finance director has *completely misunderstood the meaning of the term sustainable*. He has *assumed that it refers to the sustainability of the business as a going concern* and not of the business's place in the environment. Clearly, if a business has lasted 50 years then the business model adopted is able to be sustained over time and a healthy balance sheet enabling future business to take place ensures this. But this has *no bearing at all on whether the business's environmental footprint is sustainable* which is what is meant by sustainability in the context of environmental reporting.

(b) Stages in an environmental audit and the issues that JGP will have in developing these stages

Environmental auditing contains three stages.

The first stage is *agreeing and establishing the metrics* involved and deciding on what environmental measures will be included in the audit. This selection is important *because it will determine what will be measured against, how costly the audit will be and how likely it is that the company will be criticised for 'window dressing' or 'greenwashing'*. JGP needs to decide, for example, whether to include supply chain metrics as Professor Appo suggested, which would be a much more challenging audit. Given that the *board's preference is to be as 'thorough as possible', it seems likely that JGP will include a wide range of measures* and set relatively ambitious targets against those measures.

The second stage is *measuring actual performance against the metrics* set in the first stage. The means of measurement will *usually depend upon the metric being measured*. Whilst many items will be capable of numerical and/or financial measurement (such as energy consumption or waste production), others, such as public perception of employee environmental awareness, will be less so. Given the board's stated aim of providing a robust audit and its need to demonstrate compliance, this stage is clearly of great importance. If JGP wants to demonstrate compliance, then measures must be established so that compliance against target can be clearly shown. This is likely to favour quantitative measures.

The third stage is *reporting the levels of compliance or variances*. The issue here is *how to report the information and how widely to distribute the report*. The board's stated aim is to *provide as much information as possible 'in the interests of transparency'*. This would tend to signal the publication of a public document (rather than just a report for the board) although there will be issues on how to produce the report and at what level to structure it. The information demands of local communities and investors may well differ in their appetite for detail and the items being disclosed. Given that it was the desire to issue an environmental report that underpinned the proposed environmental audit, it is likely that JGP will opt for a high level of disclosure to offset the concerns of the local community and the growing number of concerned investors.

(c) Define 'environmental risk'. Distinguish between strategic and operational risks and explain why the environmental risks at JGP are strategic

Define environmental risk

An environmental risk is an unrealised loss or liability arising from the effects on an organisation from the natural environment or the actions of that organisation upon the natural environment. Risk can thus arise from natural phenomena affecting the business such as the effects of climate change, adverse weather, resource depletion, and threats to water or energy supplies. Similarly, liabilities can result from emissions, pollution, waste or product liability.

Strategic risks

These arise from the overall strategic positioning of the company in its environment. Some strategic positions give rise to greater risk exposures than others. Because strategic issues typically affect the whole of an organisation and not just one or more of its parts, strategic risks can potentially involve very high stakes – they can have very high hazards and high returns. Because of this, they are managed at board level in an organisation and form a key part of strategic management. Examples of strategic risks include those affecting products, markets, reputation, supply chain issues and other factors that can affect strategic positioning. In the case of JGP, reputation risk in particular is likely to be one of the most far-reaching risks, and hence one of the most strategic.

Operational risks

Operational risks refer to potential losses arising from the normal business operations. Accordingly, they affect the day-to-day running of operations and business systems in contrast to strategic risks that arise from the organisation's strategic positioning. Operational risks are managed at risk management level (not necessarily board level) and can be managed and mitigated by internal control systems. Examples include those risks that, whilst important and serious, affect one part of the organisation and not the whole, such as machinery breakdown, loss of some types of data, injuries at work and building/estates problems.

In the specific case of JGP, environmental risks are strategic for the following reasons.

First, environmental performance *affects the way in which the company is viewed by some of its key stakeholders*. The case mentions the local community (that supplies employees and other inputs) and investors. The threat of the withdrawal of support by the local community is clearly a *threat capable of affecting the strategic positioning* of JGP as its ability to attract a key resource input (labour) would be threatened. In addition, the case mentions that a 'growing group of investors' is concerned with environmental behaviour and so this could also have *potential market consequences*.

Second, *as a chemical company, Professor Appo said that JGP has a 'structural environmental risk'* which means that its membership of the chemical industry makes it have a higher level of environmental risk than members of other industries. This is because of the *unique nature of chemicals processing* which can, as JGP found, have a major impact on one or more stakeholders and threaten a key resource (labour supply). Environmental risk arises from the potential losses from such things as emissions and hazardous leaks, pollution and some resource consumption issues. CEO Keith Miasma referred to this risk in his statement about the threat to JGP's overall reputation. As a major source of potential reputation risk, environmental risk is usually a strategic risk for a chemical company such as JGP.

3 (a) Conflict of interest

Conflict of interest

A conflict of interest is a situation in which an individual has compromised independence because of another countervailing interest which may or may not be declared. In the case of non-executive directors, shareholders have the right to expect each NED to act wholly in the shareholders' interests whilst serving with the company. Any other factors that might challenge this sole fiduciary duty is likely to give rise to a conflict of interest. Does the director pursue policies and actions to benefit the shareholders or to benefit himself in some other way?

Conflicts of interest in the case

John has a longstanding and current *material business relationship with KK Limited* as CEO of its largest supplier. This creates an obvious incentive to influence future purchases from Soria Supplies over and above other competitor suppliers, even if the other suppliers are offering more attractive supply contracts as far as KK is concerned. It is in the interests of KK shareholders for inputs to be purchased from whichever supplier is offering the best in terms of quality, price and supply. This may or may not be offered by Soria Supplies. Similarly, a conflict of interest already exists in that Susan Schwab, KK's finance director, is a NED on the board of Soria Supplies. Soria has a material business relationship with KK and Susan Schwab has a conflict of interest with regard to her duty to the shareholders of KK and the shareholders of Soria Supplies.

His appointment, if approved, would create a *cross directorship with Susan Schwab*. As she was appointed to the board of Soria Supplies, any appointment from Soria's board to KK's board would be a cross directorship. Such arrangements have the ability to create a disproportionately close relationship between two people and two companies that may undermine objectivity and impartiality in both cases. In this case, the cross directorship would create too strong a link between one supplier (Soria Supplies) and a buyer (KK) to the detriment of other suppliers and thus potentially lower unit costs.

John's brother-in-law is Ken Kava, the chief executive of KK. Such a close *family relationship* may result in John supporting Ken when it would be more in the interests of the KK shareholders for John to exercise greater objectivity. There should be no relationships between board members that prevent all directors serving the best interests of shareholders and a family relationship is capable of undermining this objectivity. This is especially important in public listed companies such as KK Limited.

(b) Advantages of appointing non-executives to the KK board

The case discusses a number of issues that were raised as a result of the rapid expansion. An effective NED presence during this period would expect to bring several benefits.

In the case of KK, the NEDs could provide essential input into two related areas: monitoring the strategies for suitability and for excessive risk. In *monitoring the strategies for suitability*, NEDs could have an important scrutinising and advising role to fulfil on the 'aggressive' strategies pursued by KK. All strategy selection is a trade off between risk and return and so experience of strategy, especially in risky situations, can be very valuable.

NEDs could also *monitor the strategies for excessive risk*. The strategy role of NEDs is important partly because of increasing the collective experience of the board to a wide range of risks. With KK pursuing an 'aggressive' strategy that involved the 'increasingly complex operations', risk monitoring is potentially of great importance for shareholders. There is always a balance between aggression in a growth strategy and caution for the sake of risk management. The fact that some of the other executive directors are both new to the company (resulting from the expansion) and less experienced means, according to the case, that they may be less able and willing to question Mr Kava. Clearly, an effective non-executive presence would be able to bring such scrutiny to the board. They may also place a necessary restraint on the strategic ambitions of Mr Kava.

They could *provide expertise on the foreign investments including*, in some cases, country-specific knowledge. It is careless and irresponsible to make overseas investments based on incomplete intelligence. Experienced NEDs, some of whom may have done business in or with the countries in question, could be very valuable. Experienced NEDs capable of offering specific risk advice, possibly through the company's committee structure (especially the risk committee) would be particularly helpful.

Investors are reassured by an effective non-executive presence on a board. The fact that investors have expressed concerns over the strategy and risk makes this factor all the more important in this case. An experienced and effective NED presence would provide shareholders with a higher degree of confidence in the KK board so that when large overseas investments were made, they would be more assured that such investments were necessary and beneficial.

Finally, through an effective nominations committee, the NEDs could have *involvement in the recruitment and appointment of executive and non-executive directors* through the nominations committee structure. Specifically when the business is growing the need for new people is at its height and the *appointment of specialists at board level in such periods is strategically important*. Through the use of contacts and through the experience of recruiting directors for many years, experienced NEDs could make a worthwhile contribution.

[Tutorial note: this is a case analysis task. Do not reward the four roles: people, strategy, risk, scrutiny unless clearly used to analyse the case]

(c) Corporate governance report

Best practice CG report
Several corporate governance codes of practice prescribe the content for a report as part of an annual report. Although these vary slightly, the following are prominent in all cases.

Information on the *board and its functioning*. Usually seen as the most important corporate governance disclosure, this concerns the details of all directors including brief biographies and the career information that makes them suitable for their appointment. Information on how the board operates, such as frequency of meetings and how performance evaluation is undertaken is also included in this section. This section is particularly important whenever unexpected or unanticipated changes have taken place on the board. Investors, valuing transparency in reporting, would always expect a clear explanation of any sudden departures of senior management or any significant changes in personnel at the top of the company. Providing investor confidence in the board is always important and this extends to a high level of disclosure in board roles and changes in those roles.

The *committee reports* provide the important non-executive input into the report. Specifically, a 'best practice' disclosure includes reports from the non-executive-led remuneration, audit, risk and nominations committees. In normal circumstances, greatest interest is shown in the remuneration committee report because this gives the rewards awarded to each director including pension and bonuses. The report on the effectiveness of internal controls is provided based in part on evidence from the audit committee and provides important information for investors.

There is a section on *accounting and audit issues* with specific content on who is responsible for the accounts and any issues that arose in their preparation. Again, usually a matter of routine reporting, this section can be of interest if there have been issues of accounting or auditor failure in the recent past. It is often necessary to signal changes in accounting standards that may cause changes in reporting, or other changes such as a change in a year-end date or the cause of a restatement of the previous accounts. These are all necessary to provide maximum transparency for the users of the accounts.

Finally there is usually a section containing *other papers and related matters* which, whilst appearing to be trivial, can be a vital part of the accountability of directors to the shareholders. This section typically contains committee terms of reference, AGM matters, NED contract issues, etc.

Fin Brun's information needs
Fin Brun is voicing a reasonable and realistic concern to Mr Kava because it is usually difficult to determine the contributions of individual directors (unless there has been some other publicity, positive or negative, throughout the year). The *bonuses awarded to each director* are, however, disclosed in the report of the remuneration committee and this gives an indication of the committee's view on each director's performance. The biographies of all directors, including NEDs, is *included in a best practice disclosure and that can also provide information* on the type of person the director is and an indication of his or her fitness for the job.

[Tutorial note. The study texts approach this content in slightly different ways (different headings). Allow for variations in expression of ideas].

4 **(a)** Liquidity risk

Liquidity risk refers to the difficulties that can arise from an inability of the company to meet its short-term financing needs, i.e. its ratio of short-term assets to short-term liabilities. Specifically, this refers to the organisation's working capital and meeting short-term cash flow needs. The essential elements of managing liquidity risk are, therefore, the controls over receivables, payables, cash and inventories.

Manufacturing has historically had a greater challenge with the management of liquidity risk compared to some other sectors (especially low inventory businesses such as those in service industries like those that Bob Ndumo is NED for). In the case of UU, this is for three reasons.

Firstly, manufacturing usually requires higher working capital levels because it buys in and sells physical inventory, both on credit. This means that both payables and receivables are relatively high. It also, by definition, requires inventory in the form of raw materials, work-in-progress and finished goods, and therefore the management of inventory turnover is one of the most important management tasks in manufacturing management. In addition, wages are paid throughout the manufacturing process, although it will take some time before finished goods are ready for sale.

Secondly, manufacturing has complex management systems resulting from a more complex business model. Whilst other business models create their own liquidity problems, the variability and availability of inventory at different stages and the need to manage inventories at different levels of completion raises liquidity issues not present in many other types of business (such as service based business).

Thirdly, UU has a number of weaknesses that amplify its structural liquidity position as a manufacturer. Its ineffective credit control department and its voluntary 20 day supplier payment policy both increase the short-term cash pressure and thereby increase the likelihood of liquidity risks becoming realised.

(b) Risk embeddedness

Risk embeddedness refers to the way in which risk awareness and management are interwoven into the normality of systems and culture in an organisation. These two twin aspects (systems and culture) are both important because systems describe the way in which work is organised and undertaken, and culture describes the 'taken-for-grantedness' of risk awareness and risk management within the organisation.

The methods by which risk awareness and management can be embedded in organisations are as follows:

Aligning individual goals with those of the organisation and building these in as part of the culture. The need for alignment is important because risk awareness needs to be a part of the norms and unquestioned assumptions of the organisation. Training of staff at all levels is essential to ensure risk is embedded throughout the organisation.

Including risk responsibilities with job descriptions. This means that employees at all levels have their risk responsibilities clearly and unambiguously defined.

Establishing reward systems that recognise that risks have to be taken (thus avoiding a 'blame culture'). Those employees that are expected to take risks (such as those planning investments) should have the success of the projects included in their rewards.

Establishing metrics and performance indicators that monitor and feedback information on risks to management. This would ensure that accurate information is always available to the risk committee and/or board, and that there is no incentive to hide relevant information or fail to disclose risky behaviour or poor practice. A 'suggestion box' is one way of providing feedback to management.

Communicating risk awareness and risk management messages to staff and publishing success stories. Part of the dissemination of, and creating an incentive for, good practice, internal communications is important in developing culture and continually reminding staff of risk messages.

(c) Obstacles to embedding liquidity risk management at UU Limited

The case draws attention to three aspects of working capital management at UU Limited: payables, receivables and inventory. All of these are necessary issues in the management of liquidity and hence the reduction of liquidity risk. Specifically, however, it identifies four potential obstacles to embedding the management of liquidity risk. Primarily, however, the individual managers of the company are all acting in isolation and not working together for the good of the company.

The *sales manager's desire to have high levels of finished goods* for maximum customer choice. It is quite reasonable for a sales manager to support high levels of finished goods inventory but there is an inventory-holding cost associated with that which increases the amount of money tied up in working capital. A wider recognition of the overall liquidity pressures on the business would be a very helpful quality in the sales manager and this is a potential obstacle.

The same points apply to the *manufacturing director's desire to have high raw material levels*. Clearly, his effectiveness as head of manufacturing is partly measured by the extent to which the factory fulfils orders and avoids the disruptions to production that arise through inventory 'stock-outs'. He prefers having raw materials in stock rather than having to order them with a supplier's lead time but this, of course, leads to a greater exposure to liquidity risk.

The *ineffective credit control department*. According to the manufacturing director, the credit control department, responsible for the timely payment of receivables, was poor. The vulnerability to liquidity risk is clearly influenced by days receivables and so an ineffective credit control department is a major obstacle.

Finally, the *CEO's desire to pay payables early* as part of the company's social responsibility efforts. Brian Mills is clearly of the view that offering a voluntary prompt payment of payables is an important component of the company's social responsibility and that is costing the company an average of 10 days payables on most accounts. Over the course of a year that will place a great deal of arguably unnecessary pressure on working capital. The fact that it is the CEO himself that holds this view might make it difficult to change.

(d) Criticise the voluntary supplier payment policy

Supplier payment disclosures have become increasingly popular in recent years in some countries as a signal of intent to suppliers that larger buyers will not exploit the economic advantage that they sometimes have over smaller suppliers. It is usual for these statements to announce that all payments will be made in line with the supplier's terms and so UU's intention to voluntarily pay within 20 days is more generous that would usually be expected.

In terms of criticism as a means of demonstrating social responsibility, the case says that the purpose of the policy is to 'publicly demonstrate our social responsibility'. A key limitation of the policy is, however, that the policy *only focuses on one stakeholder* (suppliers) and apparently ignores other groups. Given the information in the case, the social responsibility policy is apparently aimed at one single stakeholder which is an ineffective overall strategy.

Secondly, however, it is unlikely that this policy is the best use of resources *if the desire is to 'publicly demonstrate' social responsibility*. Measures aimed more at customers or more charitable causes would be likely to attract more publicity if that is the intention.

The policy is *very costly to UU in terms of cash flow*. So much so that the finance director has questioned whether it can actually be afforded, especially at times of a lack of short-term credit, particularly during the global economic recession. It is, of course, a matter of ethical debate as to how committed UU should be to its social responsibility in terms of resources.

Finally, the policy *doesn't enjoy the support of the other directors* and is thus hard to maintain as an ongoing commitment. This means it is vulnerable and susceptible to change if the CEO is the only person who really believes in it. As a part of the company's overall strategic positioning, the components of social responsibility must enjoy widespread support, especially among the senior officers in the company, and arguably most importantly, it must enjoy the support of the finance director.

1 **(a)** **(i)** 1 mark for each reason identified and explained (half for identification only). (6 marks)

(ii) 2 marks for each point identified and argued in context. (half mark for identification only). (6 marks)

(b) 4 marks for distinguishing between absolutism and relativism (2 marks for each).
3 marks for evaluation of Shazia Lo's behaviour from an absolutist perspective.
3 marks for evaluation of Shazia Lo's behaviour from a relativist perspective. (10 marks)

(c) **(i)** 2 marks for assessment of each consequence of ZPT's governance failures (1 mark for brief explanation only). (10 marks)

(ii) 2 marks for each argument identified and made. (8 marks)

(iii) 2 marks for each broad theme identified and explained. (Maximum 6 marks)

Professional marks for the structure, flow, persuasiveness and tone of the answer to (c) parts (i), (ii) and (iii). (4 marks)

2 **(a)** 4 marks for explanation of sustainability.
2 marks for criticism of the FD's understanding.
Allow cross marking between the two tasks.
(6 marks)

(b) 3 marks for each of the 3 stages of the audit (1 for explanation of the stage, 2 for exploration). (9 marks)

(c) 2 marks for definition of environmental risk.
4 marks for distinguishing between strategic and operational risks (2 for each).
2 marks for explanation of each reason why environmental risks are strategic at JGP to a maximum of 4 marks. (10 marks)

3 **(a)** 2 marks for an explanation of conflict of interest.
2 marks for each potential conflict of interest identified and explained. (8 marks)

(b) 2 marks for each advantage assessed. (Maximum 7 marks)

(c) 2 marks for each section explained (allow for cross marking between points) to a maximum of 8 marks. 2 marks for explanation of information needs of Fin Brun. (10 marks)

4 **(a)** 2 marks for definition of liquidity risk.
1 mark for each explanation of manufacturing vulnerability to liquidity risk up to a maximum of 3 marks. (5 marks)

(b) 2 marks for definition of risk embeddedness.
1 mark for each method to a maximum of 5 marks. (7 marks)

(c) 2 marks for each obstacle identified and examined. 1 mark for identification only. (8 marks)

(d) 2 marks for each criticism made to a maximum of 5 marks. (Maximum 5 marks)