ACCA

Paper P1

Governance, Risk and Ethics

December 2017

Mock B – Answers

To gain maximum benefit, do not refer to these answers until you have completed the revision mock questions and submitted them for marking.

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1 D&T OIL EXPLORATIONS

Key answer tips

This question covers the areas of Corporate Social Responsibility and ethical behaviour – spanning the governance & responsibility and ethics sections of the syllabus. It will be important to manage your time to attempt all sections, **and it is absolutely critical that you respond appropriately to the verbs in the question.** Many parts of this question cannot be answered using theory, so you will need to make your own judgement and use your own ideas in answers.

The normative/instrumental stakeholder theory underpins part (b), but it is application of this theory to describe the views of Leonard and the CEO.

Your answer to (c) must include reference to the pristine capitalist part of Gray Owen and Adam's model and fit Glenda Stuarts' remarks in to it. Part (d) clearly asks for examples from the case, and answers without scenario based examples will not score well. As always, you can only rely on theory to score marks if the examiner makes no reference to the scenario, as in part a).

Well prepared candidates will have considered the 'press release' requirement and have an idea, through general knowledge and prior question practice as to how it should read. It is important to put a positive (but honest!) spin on the contents of the statement. Structure, in terms of giving the statement a part (i) and (ii) will also be important in order to score professional marks.

(a) Transparency as an underlying principle of corporate governance

Transparency relates to the need for openness and honesty. It is one of the underlying principles of corporate governance. It means openness, clarity, lack of withholding of relevant information unless necessary and a default position of information provision rather than concealment.

Assessment of importance of transparency:

There are a number of reasons why transparency is important in corporate governance. For instance, it is part of gaining trust with investors and state authorities (e.g. the government). Transparency provides access for investors and other stakeholders to company information thereby dispelling suspicion and underpinning market confidence in the company through truthful and fair reporting. It also helps to manage stakeholder claims and reduces the stresses caused by stakeholders (e.g. environmental pressure groups) for whom information provision is important. Reasons for secrecy/confidentiality include the fact that it may be necessary to keep strategy discussions secret from competitors. Internal issues may be private to individuals, thus justifying confidentiality. Finally, free (secret or confidential) discussion often has to take place before an agreed position is announced (cabinet government approach).

At D&T, transparency as a principle is being discussed in the context of keeping past control failures concealed from stakeholders. Since truthful, accurate and timely reporting underpins investor confidence in all capital-funded companies including D&T, the issue should clearly be discussed in response to the media claims.

(b) Analysis of Leonard's and the CEO's motivations for disclosing information on the lack of internal controls leading to the leak using the normative-instrumental forms of stakeholder theory

The board of D&T have a choice, to either disclose their internal control failures in response to the media discoveries or to say nothing and allow media interest to 'blow over'. Both Leonard Bye and the CEO appear to agree on disclosure but for different reasons. Their motivations can be analysed using normative-instrumental stakeholder theory.

This distinction describes two different approaches or underlying ethical motivations for following a certain course of behaviour. Often applied to the ways in which organisations behave towards stakeholders, it can be applied to any situation in which ethical motivations are relevant.

In the case, Leonard is demonstrating a normative approach to going ahead with disclosure. This means he believes disclosure should be made simply because it is the ethical course of action. It is evident from what he says that he is internally motivated. He states that full disclosure of D&T culpability in respect of the weak internal controls is 'the right thing to do'. He appears to see ethical behaviour as an end in itself. He does not seem to be taking the business implications of the proposed disclosure (in terms of a possible drop in share price for example) into account and thereby tends towards the altruistic rather than the strategic. His attitude is informed primarily by internal motivation rather than the pursuit of external reward.

The CEO, by contrast, demonstrates instrumental characteristics. He is in favour of disclosure only because it may help D&T to get certain stakeholders (for example the analysts) onside. He appears to be primarily motivated by business performance and sees disclosure of past control weaknesses as a means to further strategic objectives (not as an end in itself). His attitude to the disclosure is underpinned by questions about what can be gained, for the business, by responding to the media with full disclosure. Accordingly, he is strategic rather than altruistic in his motivation.

(c) Assessment of Glenda Stuart's remarks about D&T investors in the light of Gray, Owen and Adam's pristine capitalist position on social responsibility.

Glenda Stuart's remarks are similar to some of the positions espoused by pristine capitalist theorists.

The pristine capitalist position lies at one end of Gray Owen and Adam's continuum, farthest away from the deep ecologist position which advocates that all stakeholders are in partnership with no one groups needs presiding over the rest.

In direct contrast, the pristine capitalist believes that shareholders are the key stakeholders and that shareholder wealth maximisation underpins all corporate value. Anything that reduces shareholder wealth (such as acting in a socially responsible way) is theft from shareholders.

Glenda Stuart believes that by paying the fine due for environmental damage, D&T has completely discharged its responsibility to society. This is part of the pristine capitalist viewpoint, that once legal requirements are met, no further action needs to be taken by a corporation. It is the governments job to run society and therefore to safeguard the environment. Corporations pay tax to make this task easier for the government but once that is done, their responsibility ends.

In remarking that the primary objective of D&T's investors was to see an increase in their wealth and not an improvement in environmental safeguards, Glenda Stuart is again reinforcing her view of D&T investors as pristine capitalists. In her opinion, the D&T investor would see money spent on environmental concerns as a reduction in potential dividends or shareholder growth due to missed investment.

Glenda Stuart believes that the kind of investor who chooses an oil exploration company like D&T cannot be interested in the environment. Her expectation would appear to be that environmentally conscious investors choose corporations to invest in whose activities have no potential to damage the environment. However, if this were truly the case, it is unlikely that D&T would include reference to their environmental safeguarding in investor literature.

(d) Objectives of controls over operations

Internal controls are an essential element in any large complex organisation like D&T. Operational controls in particular are needed to help to ensure that:

- the organisation's operational systems function effectively and efficiently, for example pipe corrosion is kept under careful review and preventative controls exist in this area. The new 'aggressive inspections' may ensure this is the case.
- the assets of the organisation are being safeguarded, for example expensive infrastructure is maintained;
- the organisation complies with all the necessary laws, regulations and codes. These are likely to be particularly onerous where the oil industry is concerned.

Operating internal controls are intended to reduce risks crystallising and damaging the company and its stakeholders. The corrosion prevention system was ineffective when the leak occurred and the controls therefore not meeting their objectives.

Responsibility for review of operating controls

The board of directors in D&T is ultimately responsible for the integrity of the internal operating controls system. The head of engineering and maintenance clearly has responsibility delegated to him by the board in this area.

Controls might be ineffective. They might also become ineffective over time, as operating conditions change and as new risks arise. Within an internal control system:

Executive management has the responsibility for designing and implementing internal controls. Having established a system of controls, it should be a part of the normal responsibilities of the pipeline managers to review the controls to check that they appear to remain efficient and effective;

It is an appropriate element of an internal control system that there should be a regular independent review of risks and controls: a responsibility of an internal audit department might be to check on the efficiency and effectiveness of controls in different systems within the organisation, and report their findings to senior management and their recommendations to the line managers responsible. In the case of D&T, this kind of review is likely to be done by specialist consultants who understand the potential risks.

Importance of operating control review

D&T is a listed company, and so is likely to be required to comply with stock exchange or government requirements on corporate governance or explain its non-compliance in the annual report and accounts. For example, a requirement of the UK's Combined Code is that the board of directors should review the internal control system and satisfy themselves each year that an appropriate control system is in place – and report to the shareholders that they have done so. If the internal controls are investigated regularly by internal auditors, this should provide the board with substantial evidence for making their report to the shareholders.

It is important to realise that non-financial controls form part of this system and so disclosures on operational controls should be made by D&T.

(e) Statement to the media:

D&T has invested in many high risk operations in order to provide homes and industry with oil and currently drilling is taking place in many hostile climates around the world. As an organisation, we understand the need to take the utmost care with our operations, especially when they are taking place in areas like the East Slope, valued for the habitat it provides for rare species of wildlife.

The board of directors would therefore like to take this opportunity, in the light of the most recent media coverage, to reassure investors and the public alike, that we maintain the highest standards of safety and operational integrity.

(i) Robust internal operational controls:

We believe that strong internal controls should underpin our operations. From when our engineers and consultants first assess a potential drill site, to when, often decades later, we remove our drilling equipment from the area, we ensure that thorough internal controls systems are in operation over the use of all of our pipelines and other equipment.

Robust internal operational controls *ensure that our employees are kept safe*. In hostile, high risk environments, the routine checking and rechecking of processes keeps accident levels to a minimum. Whilst D&T accepts that the unpredictability of certain environments we operate in present danger regardless of our controls, we are proud that our aggressive inspection programme ensures such incidents are kept to a minimum.

Operational internal control also *helps manage quality* throughout D&T. Any lapse in expected high standards is picked up by our standard checks and the reason behind it investigated. This in turn *gives management all the information* they need on our internal operations. The oil industry is highly regulated the world over and via robust internal controls we can be sure we are complying with the standard expected of us by governments and other regulatory bodies.

Operational internal control *underpins investor confidence*. Investors trust the D&T board because they know it is capable of managing its internal operations. This specifically means becoming aware of and controlling known risks. Without robust internal operating controls, risks may go unnoticed and therefore unmanaged.

(ii) Changes to D&T's operational safety systems following the East Slope Bay leak

As you may be aware, drilling for oil safely can be problematic, particularly in some regions. Indeed, there are several factors that can lead to leaks and the environment surrounding our drilling location being damaged, for example freak weather conditions or slight movements of the ground beneath our drill sites. In the case of East Slope, however, the issues that have been brought to the board's attention are matters of internal control and the management of D&T would therefore like to take this opportunity to outline changes and improvements that have been made to the internal operational controls to safeguard against similar future incidents.

The pipe corrosion which caused the East Slope leak over one year ago was not picked up, despite the rigorous safety checks over all of our transit pipes which were carried out by ourselves and also our partner organisations.

The management of D&T acted quickly following the leak and the transit lines in question were replaced. New transit pipes reduce significantly the risk of corrosion and the board of D&T were happy to authorise the large amount of capital investment required to renew the infrastructure.

In addition to the replacement of pipes, a new 'aggressive' inspection programme was introduced which increased the number of routine corrosion inspections roughly three fold since the leak occurred.

Despite the tightening of internal operational controls, management are still using external consultants on an ongoing basis to look for weaknesses and assess risks at all of our drilling locations, including the East Slope.

The board of D&T remain committed to reducing any adverse impact of the company's operations on the environment, whilst still providing the world with the oil necessary to fuel industry and homes.

We would like to thank our stakeholders for their continued support of D&T and reassure them, via this press release that the company has the greatest of respect for the environment it operates within.

ACCA marking scheme

		Marks
(a)	Up to 2 marks for definition of transparency.	2
	1 mark per relevant point on advantages of transparency	Up to 4
	Maximum	6
(b)	Up to 2 marks for clear understanding of the normative-instrumental form of stakeholder theory	2
	1 mark for correct categorisation of Leonard as normative	1
	1 mark for each relevant point on normative (up to 3 marks)	Up to 3
	1mark for correct categorisation of the CEO as instrumental	1
	1 mark for each relevant point on instrumental (up to 3 marks)	Up to 3
	Maximum	10
(c)	2 marks for pristine capitalist position explained	2
	Up to two marks for clear discussion of each of Glenda Stuarts remarks in the context of pristine capitalism	Up to 6
	Maximum	8
(d)	1 mark for each relevant point made on objectives of internal operating control	Up to 3
	Up to 2 marks for each point on who has the responsibility to review the internal operating controls	Up to 4
	Up to 2 marks for each point on why review of internal operating control review is important	Up to 4
	Maximum	10
(e)	(i) 1 mark for each relevant point made on importance of internal control	Up to 6
	(ii) Up to 2 marks for each relevant point identified and examined	Up to 6
	(iii) Up to 4 professional marks for structure, content, style and layout of letter	4
	Maximum	16
Total		**50**

2 TED LTD

Key answer tips

Questions covering social and environmental footprints are regularly tested at P1 and should be familiar ground.

Part (a) has two parts and candidates need to first explain social and environmental footprints in general before going on to apply each concept to TED.

Part (b) is a straightforward stakeholder requirement and should not cause any problems.

Part (c) also has two parts to it and use of subheadings is important to split answers. An explanation of CSR should represent easy marks.

(a) Social and Environmental Footprints

Social Footprint

An organisation's social footprint refers to the impact it has on society. The social footprint evaluates sustainability in three areas of capital:

- social capital
- human capital
- constructed capital.

Organisations need to ensure that their economic activities are sustainable in each of these three areas. For example, regarding social capital, the government will set taxation rates, with those taxes being used to provide various services. Where the amount raised is less than the amount required for the provision of social capital then the activities of society as a whole are unsustainable. The government will need to raise taxes meaning that companies will pay more tax. Sustainability is achieved where the social capital needs of society are being met. It can be argued that economic activity itself is unsustainable if education is insufficient to meet the needs of society.

The importance of the social footprint is that more capital can be generated if required. E.g. people can decide to improve their knowledge. The aim of economic activity may therefore be to generate sufficient social capital, or have a large enough social footprint, to ensure sustainability.

Environmental Footprint

In the same way that humans and animals leave physical footprints that show where they have been, so organisations leave evidence of their operations in the environment. They operate at a net cost to the environment.

The environmental footprint is an attempt to evaluate the size of a company's impact on the environment in three respects

- The company's resource consumption.
- Any harm to the environment brought about by pollution emissions.
- A measurement of the resource consumption and pollution emissions in terms of harm to the environment in either qualitative, quantitative or replacement terms.

Where resource use exceeds provision, then the activity can be termed unsustainable.

TED

The social footprint left by TED can be considered in each of the three areas of capital. In terms of social capital, as pointed out by the finance director, TED pays its taxes to enable the government to provide services such as education. If taxation rates were to rise, presumably TED would continue to pay. In terms of human capital, TED provides jobs and training to the local community and pays wages which enable people to achieve a certain standard of living. Constructed capital in the locality of TED will be sufficient for them to operate and so society will benefit from the company's need for adequate road networks, telecommunications etc. The board of TED would probably consider their social footprint to be positive overall.

The environmental footprint of TED is a little more complex. As a chemical company, they have the potential to harm the environment as has been demonstrated by the leak. The thorough audit and reporting process suggested will help the board to establish whether they can act to minimise any further negative impact on the environment.

(b) 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'. TED needs to decide, for example, whether to include supply chain metrics as Professor Kumar 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 TED 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 TED 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 TED will opt for a high level of disclosure to offset the concerns of the local community and the growing number of concerned investors.

(c) Socially responsible

Social responsibility is an ethical framework which suggests that an entity, be it an organization or individual, has an obligation to act for the benefit of society at large. Social responsibility is a duty every individual has to perform so as to maintain a balance between the economy and the ecosystems. A trade-off may exist between economic development, in the material sense, and the welfare of the society and environment. Social responsibility means sustaining the equilibrium between the two. It pertains not only to business organizations but also to everyone whose any action impacts the environment. This responsibility can be passive, by avoiding engaging in socially harmful acts, or active, by performing activities that directly advance social goals.

Finance Directors' understanding

The finance director does not understand the meaning of socially responsible. In his opinion, legal compliance is all that is required to be considered socially responsible. He thinks that because TED pays the legally required taxes to the government, the organisations responsibility towards society is fulfilled.

He also believes that the organisations responsibility in respect of the leak has been discharged by the paying of the court fine. In fact, this is not the case and the rest of the board seem to appreciate that further evidence the leak will not reoccur will be needed to convince TED's stakeholders that the organisation is behaving ethically.

ACCA Marking scheme		
		Marks
(a)	Explanation of social footprint	Up to 4 marks
	Explanation of environmental footprint	Up to 4 marks
	Application to TED – up to 4 marks (NB if only environmental footprint considered limit to 2 marks)	Up to 4 marks
	Maximum	10
(b)	For each stage including reference to TED 3 marks	Up to 3 marks
	For description of each stage only maximum of 6 marks in total	Up to 6 marks
	Maximum	9
(c)	Up to 2 marks for an explanation of 'socially responsible' (1 mark per relevant point)	
	For each criticism of the finance directors understanding 2 marks	
	Maximum	6
Total		**25**

3 RISK COMMITTEE

Key answer tips

Part a) should offer the well prepared candidate easy marks for theoretical knowledge. Note that a discussion of each role is required rather than just an outline.

Parts b) and c) are trickier since they require an understanding of the scenario and the majority of marks are application. Good knowledge of the risk areas of the syllabus will be beneficial here.

As always, use of headings and subheadings can help markers award credit.

(a) Risk committees

Roles

There are five general roles of a risk committee as outlined in a principles based corporate governance code. The first is *agreeing and approving the organisation's risk management strategy, including strategies for strategic risks*. This is likely to be drawn up in discussion with other parts of the organisation, including the main board and in the case of The Western Generating Company, the engineers.

Second, *the risk committee reviews reports on key risks prepared by departments on operational risks*. These might be reports from operations (e.g. production or engineering), finance or technical departments on risks that specifically may affect them.

Third, *it monitors overall risk exposure and ensures it remains within the limits established by the main board*. Exposure is generally defined as the totality of losses that could occur and the acceptable exposure will vary according to the risk strategy. Some organisations accept a higher exposure than others because of their varying risk appetites.

Fourth, *the risk committee assesses the effectiveness of risk management systems and policies*. This is usually based on past data, where a risk has materialised, or 'stress testing' of systems where the risk has not yet materialised in order to gauge whether the systems could withstand a 'worst case scenario' occurring.

Fifth, *the risk committee approves and agrees any statements or disclosures made to internal or external audiences, such as risk reporting to analysts or in the annual report.* Shareholders have the right to expect accurate and relevant reports on the risks in their investments, and so any reports issued outside the company need to be approved by the risk committee.

(b) ALARP

Risk management is partly a trade-off between the cost of control and level of perceived risk. The principle known as ALARP means that risks should be 'as low as reasonably practicable'. There is an inverse relationship between a risk and the acceptability of that risk or, in other words, a risk is more acceptable when it is low and less acceptable when it is high.

Accordingly, risks assessed as 'high' in terms of probability and/or impact, must have credible and affordable strategies put in place for their management. The extent and cost of that risk strategy is a matter of judgement and as stated by Jonathan Swift, The Western Generating Company owes it to shareholders and customers to control costs. This means that risks cannot be completely eliminated, much as it might be preferable if they could be.

Accordingly, then, each risk is managed so as to be as low as is reasonably practicable because it can never be said that a risk has a zero value. It would be financially and operationally costly to completely eliminate the risks of exploding cables and so The Western Generating Company must live with the ever-present possibility that explosions can happen. This should not lead to complacency, but merely the awareness that the probability of occurrence cannot be zero. As stated, the engineers maintain robust controls that should reduce the probability of the risks materialising.

(c) Risk appetite

Explanation

Risk appetite describes the willingness of an entity to become exposed to an unrealised loss (risk). It is usually understood to mean the position taken with regard to two notional preferences: risk aversion and risk seeking. Both preferences are associated with different levels of returns: those that are risk-seeking favour higher risks and higher returns with the converse being true for the risk averse.

Risk-averse entities will tend to be cautious about accepting risk, preferring to avoid risk, to share it or to reduce it. In exchange, they are willing to accept a lower level of return. Those with an appetite for risk will tend to accept and seek out risk, recognising risk to be associated with higher net returns.

Risk appetite and selection

The current option of not investing in the gas has a higher threat to the integrity of the company (since the directors are aware that an explosion could cause injury) and an element of reputation risk. The reputation risk has already crystallised in the negative media coverage of the incident and the pressure on the directors to explain what happened. Offset against these risks is the reduced cost of risk management leading to greater shareholder returns and, presumably, customer savings.

The option to invest in the specialist technology has negligible risk to The Western Generating Company's integrity but a slightly higher risk that the company will face liquidity problems since it will need to be financed. It has a much lower likelihood of reputation risk but returns to shareholders will drop as a result of the investment.

The two options offer two different risk and return profiles: the current option offers a higher return to shareholders but a higher risk profile and the gas investment option offers a lower return but also a lower risk profile. If the company has a higher risk appetite it is more likely to choose to continue its current strategy and if it has a lower risk appetite it is likely to select the gas investment option.

ACCA Marking scheme		
		Marks
(a)	1 mark for each role or responsibility of the risk committee, a further mark for discussion of that role (NB do not need to be split out to score 2 marks)	Up to 10
	Maximum	**10**
(b)	For understanding the concept of ALARP	2
	2 marks for each explanation relevant to the scenario	Up to 4
	Maximum	**6**
(c)	For explanation of risk appetite	3
	For demonstrating how it could affect the decision 3 marks for each (i.e. discuss current strategy and then purchase of technology)	6
	Maximum	**9**
Total		**25**

4 GABE AND COMPANY

Key answer tips

Part a) requires some knowledge (of agency theory) but is mainly application**.** Well prepared candidates should pick the governance issues from the scenario with ease, although a full criticism of each is required rather than a list.

Requirements to 'construct arguments' are popular in P1 and it's important to study the scenario to find answer suggestions. Here, Alicia Williams had pointed out the need for an objective internal audit department.

Part c) has three separate requirements and subheadings are crucial in ensuring each part of the question is addressed.

(a) Defining and explaining agency

Agency is defined in relation to a principal. A principal appoints an agent to act on his or her behalf. In the case of corporate governance, the principal is a shareholder in a joint stock company and the agents (who have an agency relationship with principals) are the directors. The directors remain accountable to the principals for the stewardship of their investment in the company. In the case of Gabe, 80% of the shares are owned by shareholders external to the Gabe family and the board has an agency responsibility to those shareholders.

Criticisms of Gabe's CG arrangements

The corporate governance arrangements at Gabe and Company are far from ideal.

There are several issues associated with the non-executive directors (NEDs) at Gabe. It is doubtful whether two NEDs are enough to bring sufficient scrutiny to the executive board. Some corporate governance codes require half of the board of larger companies to be non-executive and Gabe would clearly be in breach of such a requirement. Perhaps of equal concern, there is significant doubt over the independence of the current NEDs as they were recruited from retired executive members of the board and presumably have relationships with existing executives going back many years. Some corporate governance codes (such as the UK Corporate Governance Code) specify that NEDs should not have worked for the company within the last five years. Again, Gabe would be in breach of this provision.

Succession planning for senior positions in the company seems to be based on Gabe family membership rather than any meritocratic approach to appointments (there doesn't appear to be a nominations committee). Whilst this may have been acceptable before the flotation when the Gabe family owned all of the shares, the flotation introduced an important need for external scrutiny of this arrangement. The lack of NED independence makes this difficult.

There is a poor (very narrow) diversity of backgrounds among board members who are all (apart from Alicia) former employees. Whilst diversity can bring increased conflict, it is generally assumed that it can also stimulate discussion and debate that is often helpful.

The fact that the directors allow Gabe to have such an inadequate internal audit function indicates poor governance. The internal audit staff do not take part in operational checks meaning that controls are not scrutinised. There may be inefficiencies or frauds which are not detected and which are likely to erode shareholder wealth.

(b) Benefits of external appointment

In practice, a decision such as this one will depend on a number of factors including the supply of required skills in the internal and external job markets. Gabe and Company is clearly struggling to find a suitable internal candidate so it could be argued that widening the search to outside of the organisation in the interests of filling the vacancy quickly makes sense, particularly given the lack of work currently being carried out by the department.

Primarily, an external appointment would bring detachment and independence that would be less likely with an internal one. Such independence is essential to an effective internal audit process since work can be carried out with no threat of self - review (this may be an issue with the former management accountant) or self - interest.

An external appointment would therefore help with independence and objectivity since the recruit would owe no personal loyalties or 'favours' from previous positions. Given that one of the other members of internal audit staff did work previously as a management accountant, the external appointment of their superior could be seen as even more crucial to ensure the former management accountants' work is not compromised.

An external appointment would give a 'new broom' effect in that the appointment would see the company through fresh eyes. He or she would be unaware of vested interests and could help to design a robust programme of internal audit work for Gabe and Company.

He or she would be likely to come in with new ideas and expertise gained from other situations and transfer best practice in from outside – a net gain in knowledge for Gabe and Company

(c) Objectivity

Objectivity is a state or quality that implies detachment, lack of bias, not influenced by personal feelings, prejudices or emotions.

It is a very important quality in corporate governance generally and especially important in audit situations where, regardless of personal feeling, the auditor must carry out his or her task objectively and with the purpose of the audit uppermost in mind.

The IFAC Code of Ethics explains objectivity in the following terms (Introduction, clause 16): '… fair and should not allow prejudice or bias, conflict of interest or influence of others to override objectivity.'

Characteristics of Objectivity

It thus follows that characteristics that might demonstrate an internal auditor's professional objectivity will include fairness and even-handedness, freedom from bias or prejudice and the avoidance of conflicts of interest (e.g. by accepting gifts, threats to independence, etc.).

The internal auditor should remember at all times that the purpose is to deliver a report on the systems being audited to his or her principal. In internal audit situations, best practice dictates this to be the internal audit committee (and then ultimately, shareholders).

In Gabe and Company, the board does not place great importance on objectivity where The Internal Audit department is concerned. This is demonstrated by the Internal Auditors reporting to the Board rather than an internal audit committee. In addition, the former management accountant cannot possibly be free from conflicts of interest, however well-intentioned he or she may be. Reviewing systems and work which one has been involved in setting up or carrying out cannot count as robust internal audit work.

ACCA Marking scheme

		Marks
(a)	1 mark for each relevant point made	Up to 4
	1 mark for identification of each criticism	Up to 5
	1 mark for brief discussion of each criticism	Up to 5
	Maximum	**12**
(b)	1 mark for each relevant point identified and briefly described	6
	Maximum	**6**
(c)	2 marks for definition of objectivity	2
	1 mark for each characteristic described	Up to 2
	1 mark for each reason why characteristics may be lacking at Gabe	Up to 3
	(reporting to the board, internal appointments)	Up to 2
	Maximum	**7**
Total		**25**