

# Corporate Governance

Sample paper

## Suggested answers

### Important notice

When reading these answers, please note that they are not intended to be viewed as a definitive 'model' answer, as in many instances there are several possible answers/approaches to a question. These answers indicate a range of appropriate content that could have been provided in answer to the questions. They may be a different length or format to the answers expected from candidates in the examination.

- 1. You have just been appointed as company secretary of a medium-sized listed company. In discussions with your chairman, you discover that he has serious concerns about the quality of decision-making by the board of directors. He believes that decisions by the board are often taken on the basis of insufficient information and without due regard for either risk or the environmental, social and governance (ESG) issues involved. He mentioned that a recent example of poor decision-making had been a decision by the board to invest a large amount of money in developing a major new product, only to discover later that there were serious concerns about the environmental impact of the product and a very high probability that the product would be banned by the government's Product Standards Agency. The board had therefore cancelled the product development project, with a large write-off of the expenditure already incurred.**

**This was just one example of badly-informed decision-making by the board and the chairman says that there have been others. He wants to improve the work of the board, but is unsure about what needs to be done, and he has asked for your views and advice in the form of a report.**

### Required

**Write a report to the chairman, advising him on the measures that might be taken to improve the quality of decision-making by the board. In the report, you should take into consideration the concerns that he has expressed and the recent example of poor decision-making that he mentioned.**

*(25 marks)*

## **Suggested answer**

To: Chairman

From: Company Secretary

Date: 1 September 2010

Subject: Decision-making by the board

### **Introduction**

This report considers some of the problems experienced with decision-making by the board of directors, and makes some suggestions on measures that may be taken to improve the situation.

### **The problems**

You have suggested that the board is perhaps guilty of poor decision-making for several reasons. Directors may be given insufficient information to reach a good decision. They also may have insufficient concern for risk or ethical issues. These problems may have a number of different causes, and a number of different solutions may be needed to deal with each of them.

### **The competence of directors**

It may seem inappropriate for the company secretary to comment on the quality of board members, but poor decision-making may be attributable to some extent to poor judgement or lack of experience of the decision-makers, or to an unwillingness of the non-executive directors to provide a sufficient counter-balance to their executive director colleagues.

As chairman, you are responsible for monitoring the performance of individual directors, as well as the board as a whole. A performance review should be carried out annually. If you consider that poor decision-making is in any way attributable to some individuals more than others, and if individuals are performing badly, you should probably suggest that they resign from the board. Failure to take action to deal with individual directors would expose you as chairman to accusations of incompetence.

To assist with the performance review, you may wish to consider using specialist external consultants. Their experience with the assessment of the performance of boards and directors may help you to identify and deal with the problems more successfully. The UK Corporate Governance Code (2010 version) includes a requirement that the performance evaluation of the boards of FTSE 350 companies should be 'externally facilitated' at least every three years. This may be worth considering in our case.

### **Insufficient information**

The board must receive sufficient relevant and timely information to help them to consider issues and reach an appropriate decision. There are several possible reasons why the board is not receiving the information it needs.

The information systems within the company may not be capable of producing the information that the directors need. For example, the financial reporting systems may be incapable at the moment of providing sufficiently reliable longer-term financial forecasts. Executive management is responsible for the design and implementation of information systems.

The information needed by the board may be available, but for some reason the executive management may be reluctant to provide it to the board, particularly the non-executive directors (NEDs). Alternatively, management may be unaware of the information that the board needs to

make its decisions. Executive directors should work constructively with their NED colleagues, but in practice there may be a culture of mistrust. Failure to provide NEDs with the information they need is also to a large extent a responsibility of executive management. The recent poor decision to invest in the new product development may be an example of management being unaware that the board needed information about the risk and environmental aspects of the decision, or deliberately kept the information from the board so that the investment could go ahead.

At the same time, it is the responsibility of you as chairman to make sure that the board receives all the information that it needs. My recommendation is that you should discuss the possible problems with the chief executive officer, and consider measures for improving the quality of information systems and the flow of information to the board. In particular, the board should make clear to the CEO that it needs information about risk, and ethical, social and environmental issues that could affect decisions.

Another possible problem is that information that the board needs is provided too late, so that directors do not have sufficient time to read it before their board meetings. This is a problem for which I as company secretary should have some responsibility, and I suggest that I should look into the matter of timeliness of information for board meetings, as a matter of some urgency.

### **Risk and decision-making**

If you consider that risk is not given sufficient consideration in decision-making by the board, you should discuss your concerns with the rest of the board. A culture of risk awareness comes from the top of an organisation, and this is a matter for which you have direct responsibility. However, the board also has collective responsibility for the effectiveness of the system of risk management within the company. The recent investment in the new product development is an example of taking a decision without adequate consideration being given to the risks involved.

My specific recommendations are that the board should conduct an immediate review of the effectiveness of the system of risk management within the company. This task may be delegated to the audit committee, with assistance from the internal audit department.

The board should formalise a system for the consideration of risk in its decision-making process. To do this, a policy on risk should be formulated within the company's strategic business plans. It is important to decide how much risk the company should be prepared to accept in its operations.

To assist the board with its understanding of risks facing the company, there should be regular risk reports to the board from the risk management committee.

### **ESG issues**

The board should seek to comply with the principles and provisions of the UK Corporate Governance Code, and report on its compliance (or non-compliance) in the annual report. This should help to focus the board's attention on governance issues.

Environmental issues are one of the main areas where a board can have responsibility for risk management and identifying opportunities. In order to give appropriate consideration to environmental issues in its decision-making, the board must agree on an environmental policy for the company. The decision to invest in the new product appears to have been taken without any consideration of the environmental – and ethical – issues involved.

This is another matter that you should discuss with your board colleagues, and your aim should be to agree an environmental policy and also to consider ethical and social issues. This may be developed in time into a formal corporate code of ethics and statement of corporate social responsibility objectives.

To introduce CSR considerations into decision-making, it is essential to agree that the objective of the company should not be profit maximisation or maximisation of shareholder wealth without due regard to wider considerations, including wider stakeholder interests and longer-term objectives, as set out in the Companies Act 2006 (section 172). Reward systems should not reward managers for achieving purely financial targets: there should also be rewards for non-financial performance and achievement of environmental and social targets. You will also need the support of shareholders for a strong environmental policy, and I recommend that, having discussed the matter with the board, you should also discuss policy with some of your major shareholders.

As a next step, I recommend that the issue of board decision-making and performance should be added to the agenda for a future board meeting, after the matter has been discussed with the CEO and senior independent director. The objective should be to make the board aware of its responsibilities and to ensure that performance will be monitored, beginning with the next annual review of performance as required by the UK Corporate Governance Code.

Company Secretary

Note: The reference in this suggested answer to the Companies Act 2006 assumes that the company in the question is a UK company. This need not have been the case.

2. **For some years Lee Tomm ('Lee') was the assistant company secretary of a large listed company but he has now decided to take up the offer of employment at a senior advisory level with a government organisation. This organisation, the Consumer Protection Board (CPB), has responsibility for monitoring and controlling monopolies and mergers in industry and for protecting the consumer against anti-competitive practices.**

**Lee is aware that the CPB has been criticised in the media for poor governance. It does not engage much with its stakeholders, such as the government department that provides its funding and consumer protection groups.**

**In his time as assistant company secretary of the listed company, Lee was involved in a variety of corporate governance matters, and he is aware of the importance of good governance. He considers this to be important for non-profit-making organisations as well as for companies, although he understands that governance priorities in the CPB should differ in some respects from those in listed companies.**

**Required**

- (a) Discuss the main differences between corporate governance in a major stock market company and governance in a state-owned organisation such as the CPB.**

*(21 marks)*

**Suggested answer**

The concept of governance is broadly the same in government agencies as it is in companies. The directors (or trustees etc) given responsibility for leading the organisation should carry out their duties and fulfil their responsibilities in the best interests of the owners of the organisation and its other major stakeholders.

In a company, the owners are the shareholders and it is often assumed that the objective of the company should be to increase the wealth or provide satisfactory financial returns to shareholders. For a government agency, the owner is the government which in turn should be acting in the best interests of the general public. However, the main objective of a government agency is non-financial, and depends on the purpose for which the agency was established. The CPB should have been given specific objectives by the government when it was formed, and

these should be 'in writing'. The directors of the board should be made accountable to the government for the achievement of these objectives.

There are differing views about the extent to which companies should consider the interests of stakeholders other than shareholders, such as employees, lenders and customers. Some companies probably give due consideration to other stakeholders. However, public sector bodies acting as agents for the government will normally be expected to give much more attention to other stakeholders, particularly the general public as a whole and also to special interest groups and pressure groups. The CPB will probably also be expected to give proper consideration to the concerns of the companies it regulates, as well as to the interests of consumers.

State-owned organisations, as well as companies, need effective leadership from their board. This requires a balanced board with independent-minded directors possessing a suitable range of skills and experience, an effective chairman, the separation of the roles of chairman and chief executive officer of the organisation, and regular performance reviews of the directors and the board.

Accountability is an important aspect of good governance. For companies, accountability of the board of directors to shareholders is achieved in several ways, including the publication of an annual report and audited financial statements and an annual general meeting. State-owned bodies should be accountable to the government through regular reporting, and may also be accountable to the legislature (in the UK, Parliament) as well as to the executive arm of the government. At least one regular annual report should be made available to the general public, so that there is some direct accountability to the people that the government has been elected to represent.

There are many ethical companies. Even so, companies pursue profits and must operate in a way that will enable them to make sufficient financial returns. Since government agencies pursue benefits for the public rather than profit, it ought to be expected that they will be much more aware of ethical issues and should be expected to act in a more ethical manner than companies.

The remuneration of senior executives is another major issue in corporate governance. The aim should be to pay enough to attract talented individuals but not to overpay. Remuneration schemes should also seek to reward executives through incentive schemes as well as basic pay. There has been some attempt in the public sector to provide incentives to executives but in the past, remuneration has not been as significant as a governance issue compared with public companies. However, in the UK from 2010, government fiscal policy has included cuts in public sector pay. This will make it much more difficult to maintain incentive schemes within remuneration arrangements for executives.

Risk management and internal control are often neglected aspects of governance. However, large companies should be expected to review the effectiveness of their internal control system and risk management system each year. Very large companies may employ risk management professionals. Although risk management ought to be given similar consideration in public bodies, in practice this is often not the case. In the public sector, 'risk' is often difficult to identify, although there should be robust internal financial controls to prevent fraud and restrict wasteful spending.

In summary, although governance in the public sector has similarities with corporate governance, there are differences in emphasis, arising out of the different culture that we should expect to find in these two very different types of organisation.

- (b) Suggest how the skills and experience gained by Lee with the listed company can be transferred and applied to his new role with the CPB.**

*(4 marks)*

**Suggested answer**

Lee was the assistant company secretary at the listed company, but it is assumed that he worked closely with the company secretary and that the company complied effectively with the requirements of best practice in governance.

His experience of compliance with the UK Corporate Governance Code should help him to assist the board of the CPB with the effective implementation of its own code of governance.

He should have an understanding of how a secretary to the board can help to make the board more effective, by ensuring a free flow of information between executive managers and the board, particularly to non-executive directors. He should also be able to help with making board meetings more effective, by ensuring that the papers for a meeting are sent out well in advance of the meeting, and that the chairman prepares a suitable agenda.

He should also be able to help the members of the board to understand their accountability to stakeholders, and the importance of accountability through reporting, and the need for transparency about the affairs of the CPB.

In summary, the corporate sector currently has more and better experience of the requirements of good governance, and Lee should be able to bring his experience and knowledge of governance issues to his role as secretary and advisor to the CPB.

- 3. You are the company secretary of a listed food manufacturing company. Your chairman informs you that he has been asked to meet with two major shareholders of the company. These are institutional investors who together own about 6% of the company's equity shares. Both of them have stated publicly their policy of socially responsible investment (SRI), and the purpose of the meeting will be to discuss social and environmental issues and the company's policy on corporate social responsibility.**

**Required**

**Write a briefing note to prepare the chairman for his meetings. The briefing note should include a discussion of the following issues:**

- (a) The nature of SRI for institutional investors and its relevance for the governance of companies.**

*(5 marks)*

**Suggested answer**

SRI is an approach to investment where the investor considers ethical, social and environmental issues when deciding how to invest. It is sometimes called 'ethical investment'.

An ethical investor may choose to avoid investments in companies that are 'guilty' in some way of activity that is considered by the investor 'not socially responsible'. For example, an investor may wish to avoid buying shares in companies that conduct research and development in genetic engineering, or avoid investing in companies that obtain large quantities of their purchases from suppliers who use child labour. Alternatively, an investor may seek to invest in companies that engage in certain types of business activity, such as companies in 'green industries' that develop environmentally-friendly products and services.

SRI has attracted the interest of a number of institutional investors, and SRI policies are also promoted by representative organisations for institutional investors, such as the NAPF and ABI in the UK.

SRI is relevant to corporate governance in companies to the extent that companies should want to attract and retain long-term shareholders, and act in the interests of their longer-term shareholders. It is also probable that if an ethical investor acquires a substantial shareholding in a company, it will try to persuade the company, through dialogue with the chairman and other board members, to adopt ethical and environmentally-friendly strategies.

**(b) The ways in which institutional investors may pursue a SRI strategy, and the social and environmental risks facing the company that may be of concern to investors.**

*(10 marks)*

### **Suggested answer**

Three different ways of pursuing a SRI strategy by an institutional investor may be identified.

The first is engagement. The purpose of this strategy is to 'engage with' the company in which the investor holds shares by identifying areas in which the company should have a more socially-responsible policy, and encourage the company's board to make improvements in the policy. Engagement may therefore involve telling the company what its policies should be to make them more socially responsible, persuading the company to change its policies in some areas (through regular meetings with its senior directors) and perhaps even offering to help with the formulation of new policies.

A second strategy for SRI is preference. With this strategy, the investor develops a set of guidelines that companies should meet. The investor will then only buy and hold shares in companies that meet those guidelines. An advantage of this strategy is that investment decisions need not be based entirely on SRI considerations. The investor can also consider the expected financial returns from an investment, and the selected investment portfolio can be a suitable balance of investments that are ethically sound and those that are not as ethical but should provide better financial returns.

A third strategy is screening. With screening, there is no engagement with the company or companies concerned. Investments are restricted to companies that pass a 'screen test' for ethical behaviour. Screening may be positive or negative. Positive screening means that companies must meet certain criteria for ethical and socially-responsible behaviour; otherwise, the investor will not buy its shares. Negative screening means that an investor will identify companies that fail to meet certain minimum criteria for socially-responsible behaviour, and will refuse to buy shares in those companies.

In order to pursue a SRI strategy, an investor has to establish a system for monitoring the behaviour of all major companies, on a continual basis, and comparing their performance against the investor's requirements.

Investors wishing to pursue a SRI strategy may also collaborate, to bring greater pressure to bear on companies that they believe are failing to meet acceptable standards.

In the case of this food manufacturing company, there are many social and environmental risks that could be of concern to investors. These will include food safety and the need to comply with health standards in food production. In addition, shareholders may be concerned about the sources of raw materials and the sustainability of the business, or the effect of food production methods on the environment. Other concerns with a food manufacturing company may be the environmental effect of food packaging methods used by the company, and food transportation methods. Health and safety standards for employees and the sourcing of materials from developing or under-developed economies might also be concerns.

- (c) Suggested ways in which the company may respond positively to the concerns of its shareholders and potential new investors about social and environmental issues, and how the company secretary may assist with these measures.**

*(10 marks)*

**Suggested answer**

In its revised Guidelines on Responsible Investment Disclosure (2007) (ABI Guidelines), the ABI emphasised the importance of environmental, social and governance (ESG) risks. The ABI Guidelines call on companies to take account of ESG risks as part of their regular risk assessment procedures, and the potential threat to both long-term and short-term shareholder value from these risks (as well as the opportunities to enhance value). The ABI also expects companies to have in place effective systems for identifying and mitigating ESG risks.

The ABI Guidelines also state that the annual report should include information about ESG-related risks and opportunities, information about risks and procedures for managing risks, and the extent to which these have been complied with.

To respond positively to concerns of shareholders and other potential investors, a company should also engage with them. It should meet with their representatives regularly and explain the policies that they are trying to adopt and pursue.

A company should also give serious consideration to methods of providing evidence to investors about their social, environmental and ethical 'credentials'. For example, companies in the UK may volunteer to join in the Corporate Responsibility Index of Business in the Community. Investors can use such indices to help them to rank companies in order of preference, or to give them a 'score' for their performance. Having joined an index scheme, a company should then seek to improve or maintain its ranking in the index.

Companies may also respond by providing information to shareholders and other stakeholders about their CSR performance. To some extent, they may do this in their annual business review. Many large companies prepare and publish a social and environmental report, providing information (some of it quantified or measured against strategic targets) about their performance.

Many public companies provide extensive information on social and environmental issues on their website, both to supplement the summary information provided in their annual report and also to provide a convenient channel of communication for investors who are interested in these matters.

Commitment to CSR policies may also be demonstrated by developing and implementing a corporate code of ethics.

However, the measures taken by a company will only convince investors if the intention is genuine and there is real interest in CSR issues by the entire board of directors.

The company secretary can assist by promoting best practice in corporate governance and acting as the conscience of the company. The secretary should make the board aware of their responsibilities for social and environmental risk management, for example, by explaining the ABI Guidelines. He or she should also encourage dialogue between the board and institutional shareholders about CSR issues, and advise the board to provide sufficient suitable disclosures about CSR policies and performance to keep shareholders adequately informed. The company secretary may also be given some responsibilities for ensuring compliance with the company's CSR policies and drafting the disclosures for inclusion in the annual report and accounts. He or she should also encourage the board to make more use of its website for providing information about CSR issues, and may be given responsibility for this aspect of the website's content.

4. **Hotbrot Company is a medium-sized listed company. Argo Plant ('Argo') is a wealthy business entrepreneur and the original founder of the company. He owns 28% of the ordinary shares and is the major shareholder, but he is no longer a member of the board of directors, having resigned several years ago when the company obtained its stock market quotation.**

**Although he is no longer a director, Argo continues to show considerable interest in the business affairs of the company. Recently he has been demanding that the board should consult him on issues of business strategy and dividend policy. He also believes that at least two non-executive directors should resign because they contribute nothing of value to the board. Two members of the board agree, and argue that Argo should be consulted regularly on important issues, given his success in leading the company in the past. However, the majority of the board members are hostile and resent Argo's continual interference.**

**After a recent argument with the chairman, Argo has threatened to sue members of the board for gross dereliction of their duties as directors. He has also demanded the resignation of a board member who is the owner of a property company that has just sold a property to Hotbrot Company at a price that Argo considers excessive. The chairman was unaware of this matter.**

### **Required**

**As company secretary, prepare a report for the chairman advising him about the appropriate measures for dealing with the board's relationship with Argo and also the various complaints that Argo has made.**

*(25 marks)*

### **Suggested answer**

In confidence

To: Chairman

From: Company Secretary

Date: 1 September 2010

Subject: The board's relationship with its major shareholder

### **Introduction**

The purpose of this report is to provide advice and recommendations about the relationship between the board of directors and Mr Argo Plant, the company's major shareholder.

Mr Plant owns 28% of the equity of the company, and should therefore expect to have some influence on decision-making by the board. A corporate shareholder owning 28% of the shares of our company would probably account for the company as an 'associate' in its published financial statements.

As a board, you should therefore try to give due consideration to the views and suggestions of Mr Plant, without necessarily agreeing to his demands.

The members of the board should be aware that they stand for re-election on a regular basis, and if Mr Plant wishes to remove from the board any director who is standing for re-election, he needs the support of other shareholders with just over 22% of the remaining equity.

## **The legal duties of directors**

Directors have a legal duty to their company and should act in what they consider to be its best interests. The best interests of the company are not necessarily those of its major shareholder, and the long-term interests of all shareholders – and other stakeholders in the company – should be considered when the board makes its decisions.

If the board does not accept the views of Mr Plant on issues such as dividend policy and business strategy, they should be prepared to discuss their reasons with him and why they think that alternative policies are in the better interests of the company.

## **Shadow director status**

Mr Plant needs to be made aware that although he has a right to make his views known to the board, he should not expect the board to comply with his views and instructions.

If the board were to take direction from Mr Plant, he would probably become a 'shadow director', with the same legal duties as all the elected members of the board. It seems unlikely that Mr Plant would want to have such a status in law. If he wanted to be a director, he would be able to put himself forward for election, with every chance of succeeding.

## **Accusations of dereliction of duties**

Mr Plant has accused members of the board of dereliction of duties. The duties of directors (such as the duty of care) are specified by law. He could bring a legal action against one or more directors, but he would need to prove that his allegations are correct. However, at this time, we have no knowledge about the nature of Mr Plant's allegations or whether they are correct.

I recommend that in your next meeting with Mr Plant, you should ask him to provide evidence to support his accusations, or otherwise suggest he should cease making them.

If there is evidence of misbehaviour or unsatisfactory behaviour by any director, you as chairman have the authority to take appropriate measures against them. In an extreme case, you could advise them to resign from the board, or face a motion of no confidence from the rest of the board.

## **Related party transaction**

The allegation of an unauthorised related party transaction by a member of the board should be investigated. Directors have a legal duty to avoid conflicts of interest, and there may be a possibility that through his involvement in the property transaction, the director put his own personal interests ahead of those of the company.

Directors also have a duty to declare any personal interest in a proposed transaction and explain the nature of that interest. A declaration of personal interest is not required if, or to the extent that, the other directors were already aware of it. Since you personally were not aware of the matter, it would seem that if Mr Plant's allegation of personal interest is true, the director is in breach of the law by failing to declare it to you or to the board as a whole.

This allegation is serious, and should be investigated as a matter of urgency. If it is true, the directors may consider it necessary to bring a legal action against the director for breach of duty, and seek reimbursement of the losses the company may have suffered as a consequence of the transaction.

## **Conclusion**

Most of the board is hostile to interference by Mr Plant, although he has two supporters. If either of these two supporters is an independent non-executive director, you should review his

independent status, and check that he is not acting as a representative and in the interests of Mr Plant.

However, I conclude with my opening comment. Mr Plant is a substantial shareholder in the company and, as such, his views should be treated with respect. Hostility by the board is unprofessional, especially if it is made apparent to Mr Plant himself.

As chairman you should continue to meet with him regularly, engage in dialogue and discuss his views and why the board may oppose them.

I should be very happy to discuss this matter with you and to assist with arranging a further meeting with Mr Plant or making this matter an agenda item for a future board meeting.

5. **The chairman of a medium-sized listed industrial company has called a board meeting to discuss risk and risk management within the company. He is concerned by a recent fall of about 40% in the company's share price, following poor interim financial results and adverse media reports claiming that the problems of the company were the result of poor risk management and exposure to excessive business and other risks.**

**The chairman has also been angered by a number of incidents reported to him by the chief executive officer.**

- (i) There has been a serious breach of health and safety regulations at a foreign subsidiary, resulting in a number of deaths and serious injuries to employees.**
- (ii) An important new IT system was introduced by the company a few months ago, apparently without adequate testing of the back-up system in the event of system failure.**
- (iii) Some large expenditures on capital assets were made without proper authorisation and invoices are not available for some of the money spent. Two managers have been dismissed as a result.**

**Required**

- (a) Explain the difference between business risk and internal control risk.**

*(5 marks)*

**Suggested answer**

Risks may be categorised in many ways. One approach is to identify risks as either business risks or internal control risks. Business risks are risks that exist in the business environment in which a company operates and the risk that selected business strategies will fail to achieve their desired objective. Risks arise from the nature of the industry in which the company operates, potential actions by competitors, macroeconomic changes, potential changes in customers or suppliers, the risk of regulatory action and so on.

Business risk is two-way risk, in the sense that actual developments in the business environment may turn out to be better than expected as well as worse than expected. Companies must accept business risk in order to make a financial return, and a problem for the leadership of a company is to decide what level of business risk is acceptable, and select a suitable balance between risk and return.

Internal control risk is risk that generally arises from factors within the company itself. It is generally downside risk, meaning that events may turn out worse than expected, but not better. Management should devise a system of internal control, with internal controls to prevent adverse events or to detect and correct them if they occur.

**(b) Suggest how a system for the management of business risk should operate within the company.**

*(10 marks)*

**Suggested answer**

Business risk strategy should be a part of the strategic business planning of the company. The board of directors should decide what the company policy on risk and risk acceptance should be, and what levels of risk are unacceptable. This involves deciding on matters such as risk appetite and risk tolerance. Strategies that would expose the company to unacceptable business risk would then be rejected in favour of strategies with lower business risk involved.

There should be a formal structure for the identification and assessment of risk. The company may establish a risk management committee consisting of senior executives, and possibly also the head of internal audit. The company may also employ risk management professionals, who may also be members of this risk committee.

The risk management committee should meet regularly to discuss identifiable risks, their potential impact and the probability of an adverse outcome because of the risk. The committee should then communicate information about risk to senior executive managers, who should then be responsible for considering measures to manage the risk. Managers should report back to the risk management committee on the measures they have taken to deal with significant risks.

The committee may also request the internal audit department to carry out investigations into some aspects of business risk. The company may also use business models to assess the potential impact of risks of company performance, for example, by means of stress testing.

The risk management committee should also report regularly to the board of directors, providing information about changes in identified risks and the measures that have been taken by management. Alternatively, the committee may report regularly to the audit committee or, if one has been established, a risk sub-committee of the board. There may also be internal audit reports direct to the board's audit or risk committee.

At least once a year, the board (or possibly the audit committee, which should then report to the board) should assess the effectiveness of the company's system of risk management. This should include an assessment of changes in the nature of risks since the previous investigation and the success or failure of risk management strategies.

The board should report to shareholders each year on the significant business risks facing the company, the measures that have been taken to manage them and business prospects for the future. In Europe, stock market companies should do this in their annual narrative business review. In the UK, this is a requirement of the Companies Act 2006 (for inclusion in the annual business review), the UK Corporate Governance Code and the FSA Listing Rules.

**(c) Using the Turnbull Guidance, explain the nature of the internal control failures in incidents (i) to (iii), above, and explain who should have responsibility for the implementation and the effectiveness of a system of internal control.**

*(10 marks)*

**Suggested answer**

The chairman is justified in his anger at the failures described in the question.

The Turnbull Guidance suggests that internal control risks can be analysed into three categories: financial risks, operational risks and compliance risks. For each category of risk there should be a robust system of internal controls.

The failure in health and safety procedures would appear to be the result of a failure in compliance controls to ensure that significant items of regulation and legislation are complied with. The compliance failure would also suggest further control failures, in weak management or poor supervision, or the use of personnel who are not properly trained to comply with health and safety requirements.

The apparent failure to test the back-up system for the new IT system would appear to be a failure in operational controls. The risk of IT failures is an operational risk, and an important control for such risks should be the existence of a reliable back-up system. It is not clear what the potential consequences of a system failure might be, so the significance of the failure is difficult to assess without further information.

Large capital expenditure without proper authorisation is one example of a failure in financial controls. A system of authorisation helps to prevent unnecessary and wasteful spending, undesirable spending and (in some cases) fraud. The absence of purchase invoices for all expenditures is another example of a failure of financial control, which could possibly be the result of fraud.

The board of directors has overall responsibility for the performance of the company, and it should ensure that the systems of internal control are effective. The controls should be adequate and they should be implemented properly. The UK Corporate Governance Code recommends that the board should carry out a review, at least annually, of the effectiveness of the internal control system.

The board or audit committee should also check that if any recommendations are made by the external auditors for improvements in internal controls, in their annual letter to management, measures are taken to deal with the problem.

Although the board has responsibility for the effectiveness of the internal control system, the system itself, including its controls, should be designed and implemented by executive management. Management should also be accountable to the board for the effectiveness of the control system

- 6. The remuneration committee of a UK listed company is having problems in reaching an agreement about the remuneration package of Ross Tuck ('Mr Tuck'), an individual who has been invited by the board of directors to become the company's new Chief Executive Officer (CEO). The lawyer representing Mr Tuck has recently made several demands that the remuneration committee is now considering. According to the lawyer, Mr Tuck would like a higher basic salary and pension contributions: he has suggested that the company should contribute an amount each year equal to 5% of Mr Tuck's total remuneration from the company, excluding the pension contributions themselves. The company operates a share option scheme for its senior executives, but Mr Tuck would like to receive long-term incentives in the form of grants of shares, depending on the achievement of agreed performance targets. He would also like his employment contract to provide for the payment of two years' basic salary in the event that the company is taken over, and, if he is dismissed for any other reason, he would want to receive one year's basic salary in full at the time of dismissal.**

**The remuneration committee has used the services of remuneration consultants, who have suggested that Mr Tuck's demand for a higher basic salary may be reasonable. The company is in the top 50% by size of its peer group of companies, and the salary that the individual is demanding is comparable with the salary for a CEO in the top 10% – 20%. Since it is the objective of the company to increase its market share, a higher basic salary could be justified.**

**The chairman of the remuneration committee doubts the value of using remuneration consultants, and is not sure how the committee should respond to the demands of the prospective CEO.**

### **Required**

- (a) Explain the advantages and disadvantages of using remuneration consultants when negotiating a remuneration package for an incoming senior executive.**

*(8 marks)*

### **Suggested answer**

#### **Advantages**

There are several advantages in using remuneration consultants to advise on the remuneration package for a senior executive.

Remuneration consultants should have extensive knowledge of remuneration packages and how they may be structured, within the guidelines of the corporate governance principles and provisions that apply to listed companies. With their experience, they should also be able to offer helpful advice to the remuneration committee on matters where the 'two sides' in the negotiation cannot reach agreement.

They should also be able to draw up the framework for a draft agreement, to provide an initial basis for discussions with the incoming executive or his/her lawyer.

Provided that the remuneration consultants are independent of the company, their involvement may help to reassure shareholders that the negotiation of remuneration packages is an objective process and consistent with best practice in corporate governance. In the UK, principles and guidelines for the role and professional standards of executive remuneration consultants have been set out in a 2009 voluntary code of conduct, issued by the Remuneration Consultants Group. Consultants who comply with this code should be expected to provide a high standard of service to their remuneration committee clients.

Directors may be potentially liable for a lack of duty and care in carrying out their responsibilities, and there is some risk that shareholders may bring a legal action against the members of the remuneration committee (on behalf of the company) where a bad decision is made. Using the services of independent remuneration consultants will reduce this risk.

#### **Disadvantages**

There are also disadvantages in using remuneration consultants.

The board of directors is responsible for approving remuneration policy and the remuneration committee is responsible for agreeing packages with individual executives. The remuneration consultants have no direct responsibilities themselves, and are not properly accountable for the advice that they give. If shareholders disapprove of the remuneration package for an incoming CEO, they may decide to vote against the re-election of any member of the remuneration committee who stands for re-election at the next AGM.

It has been recognised that when remuneration committees make recommendations about basic salary by making comparisons with a peer group of companies, there is a tendency to 'ratchet up' pay levels. This seems to have happened in the case of the advice provided about the basic salary for Mr Tuck.

There may be a tendency for remuneration consultants to suggest remuneration packages that are more complex than necessary. This helps to make them more indispensable to the remuneration committee, and may justify a higher fee.

Remuneration consultants are probably better at giving advice on the fixed elements of a remuneration package (basic salary and pension contributions) than on the variable elements – annual bonuses and longer-term incentives. The remuneration committee members should have a better understanding of company objectives and priorities, and should be able to discuss challenging targets on which to base annual and longer-term awards. However, remuneration consultants can advise on market practice for variable long-term benefits, although the remuneration committee decides the multiples and targets, based on the specific circumstances of the company.

**(b) Suggest, with reasons, how the remuneration committee should respond to the demands of the lawyer for the prospective CEO in order to maintain best standards in corporate governance practice within the company.**

*(13 marks)*

### **Suggested answer**

The remuneration committee is responsible for applying the company's remuneration policy, and it should not allow any exceptions to policy guidelines when negotiating a package with any individual executive. The UK Corporate Governance Code states that remuneration for senior executives should be sufficient to attract and retain skilled executives, but should not be excessive. The company should also be sensitive to pay and conditions for other employees in the group. If the remuneration committee agrees to demands from Mr Tuck that do not meet these broad guidelines, it would not be fulfilling its responsibilities properly. Agreeing to excessive remuneration for Mr Tuck might also expose the company to bad publicity (and so some reputation risk) and increase the risk of shareholder action (for example, voting against the re-election of any member of the remuneration committee at the next AGM, or possibly voting against the remuneration report).

There are several demands from Mr Tuck (or his lawyer) that the committee should reject.

- (i) In spite of the suggestion by the remuneration committee that Mr Tuck's basic salary could be increased in line with the top 10% – 20% of peer group companies, this is inappropriate at the moment because the company is only in the top 50%. Agreeing to a higher basic salary would also make Mr Tuck even more highly paid compared with other employees in the company.
- (ii) The UK Corporate Governance Code recommends that in normal circumstances, only basic pay should be pensionable. Agreeing to pension contributions based on total remuneration (fixed pay plus variable elements) would therefore be a breach of the Code.
- (iii) Mr Tuck wants to receive grants of shares as long-term incentives, rather than share options. The company has a share option scheme at the moment, but does not appear to have a share grant scheme. Agreeing to Mr Tuck's demands would require the introduction of a new long-term incentive scheme for the company, and this should require shareholder approval (to comply with the UK Corporate Governance Code). The remuneration committee should reject this demand, because shareholders are unlikely to approve the introduction of a new incentive scheme for the benefit of one individual.
- (iv) The demands of Mr Tuck about severance pay are incompatible with the guidelines of the ABI and NAPF. There should be no extra remuneration in the event of a takeover of the company, and the demand for two years' basic salary in such an event is unacceptable. If Mr Tuck is given one year's notice in his contract of employment, he would be entitled to this amount of pay if he is dismissed for poor performance. However, ABI/NAPF guidelines recommend that the remuneration committee should insist on phased payments, not a lump sum payment on dismissal, and that the employment contract should provide for mitigation of payments in the event that the dismissed individual finds suitable alternative employment.

The remuneration committee should insist that Mr Tuck's remuneration package should be consistent with good corporate governance principles. In the UK, this should mean compliance with the UK Corporate Governance Code and the principles and guidelines of the institutional investment groups. If Mr Tuck is unwilling to accept the committee's views, the committee should report its failure to reach an agreement to the board, and the board may then ask the nomination committee to initiate the search for a different candidate for the CEO position.

**(c) Explain how the company secretary, as secretary to the remuneration committee, may assist the committee in its dealings with Mr Tuck.**

*(4 marks)*

**Suggested answer**

As secretary to the remuneration committee, the company secretary can assist with the flow of information between the committee and other interested parties, such as the main board, the nomination committee, and the external remuneration consultants.

He or she may be required to arrange meetings between committee representatives and Mr Tuck (or his representatives). If agreement is eventually reached, the company secretary may be required to brief the company's solicitors so that a contract can be drawn up.

During the period when negotiations are still taking place, the company secretary should make sure that the committee members are aware of the requirements of the code of governance and any other requirements. (In the UK, these include the principles and provisions of the UK Corporate Governance Code and the ABI Guideline on executive remuneration and practices.) For example, the company secretary should inform the committee about any demands of Mr Tuck that are incompatible with required governance practice.

*The scenarios included here are entirely fictional. Any resemblance of the information in the scenarios to real persons or organisations, actual or perceived, is purely coincidental.*