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.

EXAMINER’S GENERAL COMMENTS

Before providing answers and comments on specific questions, I should like to make a few general comments about answers to the examination.

The standard of answers ranged enormously. Some candidates showed an excellent understanding of the subject, combined with sensible business judgement and an ability to present a well-argued point of view. Other candidates, regretfully, showed a lack of understanding of many of the topics, and either presented rather simplistic opinions, or failed to explain many of the assertions that they made. This was perhaps most evident in answers about corporate social responsibility (CSR) and reputational risk. Some candidates appeared to think that adopting CSR policies was a guaranteed way of winning customers and achieving unblemished commercial success, and others argued that the risk from having a poor reputation for CSR policy was virtually a guaranteed route to commercial failure. It is not surprising that very few candidates gave examples of specific companies were given to justify these assertions.

Most candidates were able to answer the compulsory 40-mark question and three 20-mark questions, but it is important to allocate time carefully in the examination. Some candidates appeared to have spent far too long on the compulsory Question 1, leaving themselves insufficient time to present a good answer to the other three questions. A high mark in Question 1 is no good if the answers to the other questions are poor.

A number of candidates used short lists of ideas to present some answers. These are what I call ‘bullet point lists’. Lists are acceptable as long as the answers present the points sufficiently clearly and completely for the marker to understand the point. If candidates make ‘bullet points’ that fail to sufficiently explain the point they are trying to make, and leave it to the reader to ‘fill in the gaps’, they will not get credit and will not earn marks.
SECTION A
(Compulsory – answer all parts of this question)

1. (a) Outline the main features of a two-tier board structure. (4 marks)

SUGGESTED ANSWER

- In contrast to unitary boards where all directors are members of the same board, a two-tier structure consists of two boards, a supervisory board and a management board.
- Two tier boards are common in Germany.
- The supervisory board consists of Non-Executive Directors (NEDs), and is led by the company Chairman. In Germany, the NEDs are mainly not independent and may be former executives or represent interests such as employees and major shareholders.
- The management board consists of Executive Directors, and is led by the Chief Executive Officer.
- The management board is responsible for ‘managing the enterprise’, for risk management, and for developing and implementing corporate strategy. However, the work of the management board on strategy must be co-ordinated with the supervisory board.
- The role of the supervisory board is mainly to advise and supervise the management board. In addition, the supervisory board must be involved in any decision that is ‘of fundamental importance’ to the company, for example, a decision that would significantly affect the company’s assets, financing or earnings.
- The two boards should ‘co-operate closely to the benefit of the enterprise’. The success of corporate governance depends on a good working relationship between the supervisory board and the management board, and in particular, on a good working relationship between the company Chairman and the head of the management board.

Other relevant points were also given credit.

EXAMINER’S COMMENTS

Most candidates provided a reasonable or very good answer to this question.

(b) Explain the meaning of the term ‘insider dealing’, and indicate the sanctions which may be attached to this activity. (4 marks)

SUGGESTED ANSWER

- Insider dealing is the use of inside information by an insider to deal in shares of a company to make a profit.
- Inside information is price-sensitive information that has not been released to the public, but when released could have an effect on the share price of the company. For example, it could be information about takeover discussions between two companies that are nearing agreement, but are still ‘confidential’.
An insider is any person with access to inside information. They include directors and senior executives of a company, their professional advisers, and any other person who is given the inside information by an insider. Receiving inside information makes a person an insider.

Insider dealing is a criminal offence in various countries. In the UK, it is a criminal activity under the Criminal Justice Act 1993. Insider dealing is a criminal offence in the UK, and if found guilty, an individual would face a fine and/or imprisonment. However, the burden of proof is high, and there have been only a few successful prosecutions in the past.

**EXAMINER’S COMMENTS**

Many candidates answered this question well, although there were some common faults. Some candidates failed to mention that insider dealing meant buying or selling shares of a company: an obvious point to make, but candidates may have assumed (wrongly) that the point was so obvious that it needn’t be mentioned.

Many candidates discussed the rules for directors on dealing in their company’s shares during ‘close periods’. Although the reason for the close period rules is to prevent insider dealing, they do not explain the general law on insider dealing.

(c) Outline what a director’s ‘duty of skill and care’ entails. (4 marks)

**SUGGESTED ANSWER**

- A duty of skill and care for directors has been an item of common law in the UK, and is now included as a legal duty for directors in the Companies Act 2006.
- The duty is owed to the company (rather than the shareholders).
- It is a duty not to act negligently in carrying out his or her duties as a director.
- The level of skill and care required has been set in the UK by case law (for example re D’Jan of London).
- The standard of skill and care expected is the higher of: (i) the skill that the director would ‘objectively’ be expected to have as a person in his particular position in the company; and (ii) the knowledge, skill and experience that the individual actually does have. Some candidates used the standard of skills expected of a finance director as an example.
- Directors could be made personally liable for losses suffered by the company if found to be in breach of this duty.

**EXAMINER’S COMMENTS**

Again, there were many good answers to this question. However, there were some common faults too:

- Many candidates failed to mention that the duty is a legal/statutory duty.
- Some candidates discussed the fiduciary duty of directors in UK law, which is a different duty.
• Some candidates listed all the statutory duties of director in the Companies Act 2006. However, the duty of skill and care is only one of them, so the list was not required.

(d) Summarise the main principles relevant to corporate governance in the public sector. (4 marks)

SUGGESTED ANSWER

This question was looking for answers that discussed Nolan’s principles of corporate governance in the public sector. As there are seven of them, candidates would have had time to write only very briefly about these principles. They are:

• Selflessness - holders of public office should take decisions in the public interest, not for personal benefit.
• Integrity - holders of public office should not place themselves under any obligation to another person, who might use this obligation to exert influence.
• Objectivity - decisions should be made for rational reasons, and selections/choices made on merit.
• Accountability - holders of public office should be accountable to the public for their actions.
• Openness - holders of public office should be as open as possible about the decisions they make.
• Honesty - they should also act honestly.
• Leadership - they should promote the other principles through leadership and by setting an example.

EXAMINER’S COMMENTS

Candidates who recognised that the question related to the Nolan principles usually provided an answer that was adequate or better. The main problem experienced by candidates was to confuse ‘public sector’ with ‘public companies’, and to write about corporate governance in companies. Candidates were given credit if they did not mention the Nolan principles, but wrote sensibly about issues related to the principles.

(e) Explain the meaning of the term 'stakeholder', providing examples of stakeholders in your answer. (4 marks)

SUGGESTED ANSWER

• ‘Stakeholder’ must be defined. A stakeholder or stakeholder group for a company is any individual, entity or group of individuals or entities whose interests are affected by what the company does.
• This definition needs examples and explanation. The examples could be used to provide explanation.
• Lenders to a company are stakeholders because they have put money into the company, and wish to have the money repaid with interest. They will be concerned with anything that increases the risk of non-payment.
Employees of a company have an interest in what their company does. The company is their employer, and they are dependent on the company for their jobs, salaries, work experience, training, career prospects and so on.

The general public may be significant stakeholders for a large company because the company may have an impact on the economy as a whole, and on the environment.

**EXAMINER’S COMMENTS**

Virtually all candidates defined ‘stakeholder’ adequately, and listed some examples. However, these candidates obtained only adequate marks because they failed to explain the definition sufficiently. As indicated above, the examples should have been used to explain the meaning of ‘stakeholder’ more clearly.

(f) **What are the main requirements of the Sarbanes-Oxley Act?** (4 marks)

**SUGGESTED ANSWER**

A lot of information could be provided about the Sarbanes-Oxley Act, but the question was looking for a brief (but clearly-explained) list of the more significant elements of the Act from a corporate governance perspective.

- The Act is US legislation containing statutory requirements relating to corporate governance.
- The Act requires all companies with a listing in the US to provide financial statements that are certified by the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO) in order to vouch for their accuracy (section 302).
- Section 404 requires each annual report to include an internal control report stating the responsibility of management for internal control, and containing an assessment of the system of internal control in the company. Material weaknesses in internal control should be disclosed.
- The CEO and CFO must give up previous bonuses in the past 12 months if the accounts are subsequently found to need re-stating.
- There are restrictions on the type of non-audit work that can be performed for a company by its firm of external auditors.
- The Act provides some protection for whistleblowers.
- It established the Public Company Oversight Board.
- It introduced penalties for document shredding.

**EXAMINER’S COMMENTS**

The main requirements were to discuss section 302 and section 404, but credit was given for other relevant items in the Act. Many candidates could remember some elements of the Act, and were given marks accordingly.

(g) **What approach to corporate governance has been adopted by the European Union (EU)?** (4 marks)
**SUGGESTED ANSWER**

- The EU has been following a programme to improve the general standards of corporate governance in member states.
- Each member state has its own voluntary code of corporate governance for stock market companies, and the EU requires these companies to adopt a ‘comply or explain approach’ to a selected Code.
- The EU can also introduce corporate governance measures into national law by issuing Directives.
- Candidate should have been able to mention at least one directive relating to company law: examples are the Modernisation Directive that introduced a requirement for an annual business review. There are now (since 2008) laws relating to audit committees and the publication of an annual corporate governance report. In 2009, the Shareholder Rights Directive (to improve voting and information rights for investors holding shares of companies in other EU states) will be introduced into national laws of EU countries, although this will have relatively little effect on the UK.

Candidates who mentioned business review, audit committee or shareholder rights were given credit.

**EXAMINER’S COMMENTS**

Many candidates clearly found this question difficult to answer, and struggled to find anything relevant to write. One or two candidates even confused the EU with the OECD and the Commonwealth.

(h) **Outline the benefits of corporate social responsibility (CSR) for companies.**

(4 marks)

**SUGGESTED ANSWER**

- A brief definition of CSR would have been useful. CSR is responsibility shown by a company for the broader interests of society as a whole, and for stakeholders other than shareholders. It includes concern for the environment, employees and society in general.
- It has been suggested that companies with CSR policies tend to be better managed and more successful commercially, although there is no conclusive evidence of this.
- From a business case perspective, improving CSR improves corporate reputation among stakeholders of the company. By improving reputation and stakeholder relations, the company is likely to perform better over the medium to long-term.
- Some institutional investors are required to report on the extent to which they take socially responsible investment into consideration when making investment decisions. There is a stronger probability of support from the investment community for a company with good CSR policies.
- Paying attention to CSR is important in terms of risk management. There are many risks related to poor CSR, including environmental and human rights-related risks. Such risks can destroy reputation and impact on share value.
CSR is also associated with conducting business in an ethical way. A company’s business might benefit from the trust between suppliers and customers that comes from ethical dealing.

Cynical candidates may also have commented that CSR policies give companies an opportunity for favourable public relations, which is an aspect of marketing.

EXAMINER’S COMMENTS

Many students failed to shown much commercial sense or realism when answering this question. Many asserted, without any justification, that CSR policies definitely did improve a company’s reputation and, as a result, customers would buy more, profits would increase, investors would put more capital into the company, the share price would go up, and employees would not want to leave the company.

(i) What is the role of internal audit? (4 marks)

- Internal audit is an independent appraisal activity within an organisation. It acts as a form of control.
- Its function is to check the functioning and the adequacy of other controls.
- The controls that are checked by internal audit are mainly internal controls, which are categorised by the Turnbull guidelines into financial controls, operational controls and compliance controls. Internal controls are part of the system of internal control.
- Financial controls are controls over accounting procedures, to try to ensure that accounts and financial statements are ‘accurate’, to help to protect the organisation’s assets, and to prevent or detect fraud.
- Operational controls are controls within operational systems and procedures to prevent or detect failures due to operational error, such as human or technical error.
- Compliance controls are controls to ensure that the organisation is complying with key regulations, such as health and safety regulations.
- There is no statutory requirement for internal audit, but the work of internal audit can help the directors of a company to monitor and report on the effectiveness of the company’s system of internal control.
- Internal auditors may also do other audit checks, such as value for money audits and special investigations (such as IT audits).
- Comments about the need for internal auditors to be independent would have been relevant. Internal auditors are often employees, and so report to a senior line manager such as the Finance Director. However, it is a requirement of good governance that the internal auditor should have ready access to the Chairman of the board and the audit committee.
- It would also be relevant to state that internal auditors may be involved in the risk management assessment process within an organisation.

EXAMINER’S COMMENTS

Most candidates had very little to say about internal audit, and many appeared to have little or no idea what it was. Since the origins of concern for good corporate governance
were misleading financial reporting, weaknesses in auditing and weaknesses in internal controls, this lack of understanding is both surprising and disappointing.

(j) Discuss the importance of a written service contract for a director.

(4 marks)

SUGGESTED ANSWER

- A service contract is a contract of service between a director and a company.
- A service contract should ideally be in writing, but could be verbal.
- In today's business environment, we are moving towards a 'paper trail' society where organisations generally prefer to have everything in writing. This applies to directors' service contracts.
- For accountability purposes, a detailed written service contract is important to ensure both the company and the director carry out their duties effectively.
- Answers should mention the main items that would be included in a written contract, and suggest that having these matters in writing would be very useful in the case of any dispute in the future. Agreements cover responsibilities, remuneration, notice period, conditions relating to dismissal, minimum time requirement (in the case of NEDs) and so on.

EXAMINER’S COMMENTS

Most candidates were able to discuss items that are included in service contracts for directors, and quite a few mentioned the legal requirement in the UK for written contracts to be available for inspection before an AGM. A surprising number of candidates, however, failed to refer at all to the reasons why service contracts ought to be in writing, concentrating exclusively instead on what service contracts should contain. Failure to answer the question set makes it difficult to earn high marks.

SECTION B

(Answer THREE questions from this section)

2. An employee, Fred, working in the accounts office of a medium-sized company listed on the London Stock Exchange, was working late one evening during the week. He realised he had left his pen in the boardroom at an earlier meeting and, given its value, went upstairs to look for it. As he approached the door he heard the following discussion:

“Chief Executive: I am deeply concerned that if this fall in profit figures is disclosed in the next annual report, there will be all sorts of problems with the shareholders. We may even lose a number of big investors.

Non-executive director (also the cousin of the Chief Executive): (large sigh) Well, I suppose we could always find a way of making them look better.

Chief Executive: How? I can't see it at all.
Non-executive director: Well, we could make them just slightly higher than last year’s figures by including the proceeds of the sales of our toothbrush division.

Chief Executive: But the sale doesn't go through until October.

Non-executive director: No, but it will ... and it doesn't make much difference, we need the money on the books now.

Chief Executive: But when the accounts are signed off, won’t that be fraudulent?

Non-executive director: Not really ... I don’t see why ... it’s just a manipulation of timing rather than numbers.

Chief Executive: OK. That sounds good to me. Let’s sort it out now.”

Fred heard one of them move towards the door, and quickly slipped back to the stairs. He left work and spent the evening worrying about what he should do, if anything. He decided he would anonymously ask the Company Secretary how he could deal with this situation, and bring the issue out into the open.

(a) As Company Secretary you receive a report from the employee about the overheard conversation.

Write a brief summary for board members of the corporate governance problems raised by this employee, and the weaknesses in the company’s corporate governance which are evident from the conversation which was overheard. (10 marks)

SUGGESTED ANSWER

An answer to this question could have included the following:

- The CEO and NED have discussed a proposal to ‘manipulate’ or ‘window dress’ the financial statements. Financial statements are required to give a true and fair view, and in the case of UK listed companies, they should comply with international accounting standards. The proposal to alter the financial statements is probably fraudulent. At best it is unethical and reprehensible, and should not be tolerated by the other directors.
- The CEO appears to believe that the proposal to alter the accounts can be put into practice. This raises a number of questions about responsibilities for financial reporting by a company. The board as a whole is responsible for the financial statements, and the ‘misleading accounts’ would require board approval. The external auditors should be expected to state that the manipulation of the figures is unacceptable, and draw the matter to the attention of the board with the threat of issuing a qualified audit report. There are also questions about the role and effectiveness of the audit committee,
which has the responsibility for monitoring accounting policies used by the company.

- The proposal also raises questions about the ethics of the company and its leaders. The CEO and NED are prepared to act in an unethical manner: ethical issues such as transparency of financial reporting, honesty and integrity could be mentioned. Unethical business practices are incompatible with good corporate governance.

- In the UK, the directors would also be exposed to a charge of failing to comply with their statutory duties to the company.

- The NED in the case study is clearly not independent, since he is a cousin of the CEO. It is permitted to have NEDs who are not independent, but the fact that there is a non-independent NED raises questions about the balance of the board.

- There must also be concern about the fact that the CEO and NED appear to be acting together, so that the CEO might have a small ‘power base’ of directors colluding with each other.

- Collusion between directors and a lack of business ethics, taken together, could suggest a high risk of fraud.

- Questions may therefore be raised about the role of the nominations committee in appointing this NED to the board.

**EXAMINER’S COMMENTS**

There was a lot to write for this question, but many candidates failed to discuss the issues adequately. Many were unwilling to consider the implications of misleading financial reporting, and so did not offer the opinion that this is unacceptable. Far too many candidates also made the incorrect assertion that NEDs must be independent. This is not correct, but the existence of non-independent NEDs does raise questions about balance of the board and will be studied closely by institutional investors. A large majority of candidates failed to discuss any ethical issues.

(b) Draft a whistleblowing policy statement for any organisation, taking account of the ICSA Best Practice Guide. **(10 marks)**

**SUGGESTED ANSWER**

- The internal whistleblowing procedures should be documented, and a copy should be given to every employee.

- It should set out the main aspects of the procedure for whistleblowing, such as the conditions in which employees may wish to report their concerns without going through normal line management reporting channels. Initially, reports may be made to the Company Secretary or the internal auditor.

- The policy should contain a statement that the employer takes any malpractice or misconduct by its employees seriously, and is committed to a policy of encouraging employees to report their genuine concerns without fear of victimisation or punishment.

- The policy statement should give examples of the type of misconduct that may be reported through the whistleblowing procedures, and should indicate the
level of proof that a whistleblower would be expected to provide to justify his or her concern.

- The statement should also explain the procedures that would be followed to investigate an allegation.
- It should also make clear that any malicious allegation would result in disciplinary action against the individual making them.
- No employee will be victimised for making a genuine allegation.
- In some cases, an external reporting route may be offered as an alternative to an internal reporting route.
- As far as possible, whistleblowers should be informed of the outcome of their allegations and the subsequent action taken to investigate them.
- Whistleblowers should be offered confidentiality, as far as this is practicable.

EXAMINER’S COMMENTS

Many candidates successfully made many of these points, and on the whole part (b) was well answered. The main problem for some candidates appeared to be lack of time, so that answers to part (b) were presented as a sketchy list of bullet points.

3. You are the Company Secretary of a large UK multinational company operating in the energy sector. Your company has operations in 25 different countries, some of which are developing economies, and it has raised debt finance, as well as equity finance, in 15 of these countries. You are aware that there have been protests from environmental lobby groups in several areas regarding oil pipelines. There have also been demonstrations about the impact of operations on local communities.

Your company has an internal audit committee, an audit committee, and a reasonably well-developed system of internal control loosely structured around the Turnbull Report’s recommendations. However, the board has decided that perhaps it should form a new committee, a ‘risk committee’, which will deal with risk management and internal control specifically.

Accordingly, the board has asked you to prepare a briefing paper which summarises the main risks facing the business at present, and the relative importance of these risks to the business, to highlight where the primary exposures are likely to be.

(20 marks)

SUGGESTED ANSWER

This question asked for a summary of the external and internal risks facing a large multinational company in the energy sector. The question also appears to indicate that the company is involved with oil pipelines; therefore it would be appropriate to think of companies such as Esso, Shell and BP.

The question was demanding, in the sense that it required the application of risk identification and risk assessment to a case study, but with only limited time to come up with ideas and present them convincingly.
Answers should have discussed risks within categories. There is no ‘correct’ answer to this question, and the following points are simply ideas that candidates may have chosen to include:

- **Business risk.** This is risk arising from the possibility of unexpected developments in the business environment for oil companies. There is a business risk arising from potential variations in the price of oil. At the time of the examination in November 2008, oil prices had been through a period of huge price fluctuations between a peak price of about $150 a barrel and a low price near $30 a barrel. This creates huge difficulties for oil companies. When oil prices fall to a very low level, it may be difficult to operate at a profit. The variations in price were linked to the condition of the global economy and the demand for oil.

- **Environmental risk.** Oil companies face environmental risk, which is the risk of changes in environmental conditions that could affect the company. An obvious risk is the limit to the supply of oil and gas as natural resources, and the problems of finding new sources of supply. There are also risks from environmental pollution in the extraction and movement of oil, which could expose the company to heavy fines.

- **Combination of business risk and environmental risk.** Climate change is bringing a demand for renewable sources of energy. Multinational oil companies are aware of this, and are investing in ‘green’ technology. This will create major business opportunities in the future, but there is also the risk that a competitor will be more successful in developing products and technologies based on renewable energy. The combination of business risk and environmental risks are therefore possibly the biggest risks facing the company.

- **Health and safety risk: legal risk.** The risks from failure to comply with health and safety requirements. Injuries to employees or the general public from accidents at processing plants could result in high penalties.

- **Political risk.** Oil companies operate in many countries where the government may be unstable, or where the government is challenged by rebel groups. There is a risk of government action against companies, for example, the risk of nationalisation or part-nationalisation, or by political groups or local populations opposed to central government. At least one offshore oil platform of a major multinational has been attacked by regional ‘bandits’.

- **Many candidates discussed reputation risk.** If an oil company damages the environment, kills or injures people due to accidents or is the subject of attacks from political opposition groups, the damage to its reputation may also affect its business. For example, there may be some fall in customer demand for their products, although evidence of this is by no means conclusive.

- **Financial risks.** The company operates in 25 countries and has raised finance in 15 countries (an unusually large number of countries). It operates globally, and presumably has raised money in a variety of different currencies. It is therefore exposed to a variety of financial risks. These are risks of losses or threats to the stability of the business from unexpected changes in financial conditions, such as major changes in interest rates or foreign exchange rates. In a ‘credit crunch’, which existed at the time of the examination, there is a risk from being
unable to renew loans when existing loans fall due for repayment. There may also be risks from borrowing too much, especially if profits are falling.

- The examination question refers to internal control, and it would therefore be appropriate to discuss the need to ensure that internal controls are sufficient and effective. For an oil company, compliance with health and safety regulations would seem important, but compliance with operational and financial controls is also necessary.

**EXAMINER’S COMMENTS**

Although there was no 'right' answer, the best marks were given to candidates who demonstrated an ability to think critically, explain their risk assessment and grading of risks, and who could support their views with sensible arguments.

Many candidates produced disappointing answers to this question. There was widespread lack of understanding of business risk, and only superficial understanding of financial risks. A large number of candidates virtually restricted their answer to a discussion of reputation risk and risk from a breach of internal controls. Candidates who suggested that these are the biggest risks facing a multinational oil company demonstrated a substantial lack of commercial and business awareness.

4. **You are the Secretary of a company which is going through the process of moving from the Alternative Investment Market (AIM) to a full listing on the London Stock Exchange (LSE). The board has been having regular meetings, and at the last meeting decided it was worried about disclosures relating to directors’ remuneration. In fact, one of the board members has told you confidentially that none of them are certain which information needs to be disclosed, which information will be audited and which will not. Until now, remuneration has not been disclosed in the company’s annual reports, and with the new listing the board feels that this has to change quickly. Prepare a summary of requirements and best practice relating to the disclosure of directors’ remuneration, and the audit of this information, for the next board meeting. (20 marks)**

**SUGGESTED ANSWER**

Relatively few candidates attempted the question, which related to the disclosure of information on directors’ remuneration in the UK. The requirements for a directors’ remuneration report apply to all quoted companies; therefore the fact that the quoted company in the question had not made any disclosures in the past should have been highlighted. Failure to prepare such a report by a quoted company is against UK law, and raises questions about the external auditors whose duty includes a duty to audit a part of the report.

Good marks were obtained by referring to UK legislation (the Companies Act, but reference to the Directors’ Remuneration Report Regulations was acceptable), and by
itemising the disclosures that are subject to audit and are not subject to audit. In this sense, a factual answer was required.

Information to be disclosed, but not subject to audit:

- The name of each director who was a member of the remuneration committee.
- Names of any person who gave advice to the remuneration committee.
- A statement of the company’s policy on directors’ remuneration for the next year and subsequent years.
- For each director, this should include a detailed summary of any conditions attached to the award of share options or other awards under a long-term incentive arrangement. This summary should explain why these performance conditions were chosen. If any awards to the director are not subject to conditions, the reasons should be explained.
- The report should also contain a performance graph, showing total shareholder return for the company and total shareholder return for an index of similar companies over the same period (the five most recent financial years).
- Details about the service contract of each director, such as the unexpired term of the contract or notice period required, and provisions for compensation payable on early termination of the contract.

Information subject to audit:

- The report should disclose details of total salaries and fees, total bonuses, allowances for expenses, any compensation for loss of office, and non-cash benefits for each person who served as a director during the financial year.
- Details should also be provided about share options for each director, such as share options awarded and options exercised. For options not yet exercised, details should be given of the amount of the options, when they are exercisable and the exercise price, and when the options expire.
- Details should also be provided for each director about any long-term incentive scheme, and any pension rights to which the director is entitled.
- If a director was removed from office during the year, details should be provided of the compensation paid for loss of office.

A good answer would comment on the fact that auditors are only able to audit verifiable facts, which is why all the report is not subject to audit. Answers should also have briefly commented on the fact that the remuneration report is the subject of a shareholder vote at the AGM, and the shareholders rely on the auditors’ verification of the auditable information in the report.

EXAMINER’S COMMENTS

Candidates who had learned the details of the regulations performed reasonably well, although some candidates presented short and incomplete lists of items. A warning about examination technique is appropriate here too. The question asked about requirements ‘relating to the disclosure’ of directors’ remuneration. However, a number of candidates chose instead to write about directors’ remuneration generally, failed to answer the question set, and so failed to earn marks.
5. You have been asked to present a paper at the next board meeting which:

(a) defines sustainability; (5 marks)

SUGGESTED ANSWER

This question was in three parts. The first two parts were relatively easy to answer well, but the third part, worth 10 marks, was more difficult and called for careful thought to prepare a good answer.

- Sustainability was defined in the Brundtland Report (1987) as ‘development that meets the needs of the present without compromising the ability of future generations to meet their own needs.’
- Good answers gave an example. A popular example was a company that felled trees for timber trying to ensure that they planted enough new trees to ensure future supply.
- Very good answers commented that the definition is unsatisfactory, because it leaves open the question of what exactly the needs of future generations are. It could mean the minimum required to survive, or it could mean something different.

EXAMINER’S COMMENTS

Long answers to part (a) were not needed to achieve high marks, and a surprisingly high number of candidates mentioned the Brundtland report by name and even quoted the definition. Some candidates, however, discussed the ‘going concern concept’, which is a financial concept, and is different from sustainability.

(b) explains the importance for the company of adopting a sustainable approach to its operations; and (5 marks)

SUGGESTED ANSWER

- Many companies rely on natural resources for raw materials. Without a sustainable approach to operations, companies may find that at some time in the future some key materials may run out. If this happens their existence will be threatened. Sustainability can therefore be an essential feature of long-term planning.
- There is growing awareness among governments and the public of the threats to the environment from business activities, and it is certain that over time the demand for a more sustainable approach to business will grow. Unless companies take action on their own initiative, they will eventually be forced to comply with regulations imposed on them by government.
- As environmental issues become more important, it seems likely that companies that do not adopt policies on sustainability will suffer ‘loss of reputation’. This could affect customer demand for their products, and may
deter institutional investors who have policies on socially responsible investment.

- The growth in awareness of the need for sustainability in business will create new business opportunities, with new products and services, and possibly even entirely new industries. Entrepreneurial companies should want to be in the vanguard of any innovation, in order to succeed commercially and develop their business.

**EXAMINER’S COMMENTS**

Many candidates repeated views they had already expressed in their answer to Question 1(h), suggesting that sustainability, like CSR more generally, was a way of achieving lower reputation risk, higher sales from grateful customers (and so higher profits), and more investment from environmentally-aware investors (and so a higher share price). These answers may have been adequate, but certainly failed to earn high marks.

(c) explains the links between corporate performance, and corporate social responsibility.

(10 marks)

**SUGGESTED ANSWER**

- Corporate performance may be associated with financial performance. If so, the link between good financial performance and CSR is not ‘proved’.
- However, there is a view that companies with positive CSR policies tend to be well-managed, and so are more likely to be successful in the longer term.
- Although companies are required to report their financial performance in their annual report and accounts, there is now a requirement for quoted companies in the EU to provide more non-financial information in their annual business review, including forward-looking information and details on any significant social or environmental risks. Shareholders expect to see non-financial information, much of it linked to CSR, as well as financial information.
- CSR policies are developed for a variety of different stakeholders, not just shareholders. Stakeholders have an interest in different aspects of a company’s performance. Employees are interested in how a company has treated them. The public and socially-aware investors are interested in other social and environmental aspects of performance. This is why many public companies publish annual CSR reports. A reference could be made to the requirement for some institutional investors to consider the CSR policies of the companies in which they invest.
- Some companies recognise the need to set targets and to achieve levels of performance in finance, social matters and environmental matters (and possibly also corporate governance practice). Sustainability reporting (triple bottom line reporting) can be used to report on measurable targets and actual achievements in each of these three areas – financial, social and environmental.

**EXAMINER’S COMMENTS**

Many answers to this part of the question were disappointing, because candidates chose to write about CSR and how CSR issues may be reported, but did not specifically
consider the link between corporate reporting and CSR. A simple statement to the effect that CSR issues are now widely expected in corporate reports may have been sufficient, but most candidates did not present this point in a coherent and structured answer.

6. Some commentators have questioned the contribution which non-executive directors (NEDs) may make to the work of the board. Discuss the criticisms which have been made concerning the effectiveness of NEDs.  

SUGGESTED ANSWER

This was a popular question, and many candidates answered it well. They were aware of the main criticisms of NEDs, and explained them with varying degrees of depth and analysis.

- NEDs are appointed to the board of a company to bring balance to the board, and to contribute to decision-making by contributing views and opinions based on their skills and experience.
- In large public companies in the UK, a majority of NEDs should be ‘independent’ as defined by Higgs and the Combined Code. However, all directors are expected to display independence of mind and opinion when acting as a director, even if they are not ‘officially’ classed as ‘independent’.
- Independent NEDs also act as a check on the power of executive directors to control the company, which is why the audit committee and remuneration committee should consist entirely of independent NEDs.
- Although this is what NEDs should contribute to a company and its leadership, they have been criticised for failing to do so. Many of the criticisms are connected.
- It has been argued that NEDs do not understand enough about the business of the company, and so are unable to contribute effectively to strategic decision making. Executive management may restrict the flow of information to NEDs, but there are also limits to what an NED can know about a business where he or she is engaged part-time. No candidates mentioned any examples, but this criticism has been made fairly recently against NEDs of collapsed banks or banks that needed government funding to survive during 2008. (As a counter to this argument, it could be stated that it is the responsibility of the Chairman, supported by the Company Secretary, to ensure that NEDs are provided with sufficient information.)
- It is also argued that NEDs are unable to spend enough time in a company to contribute adequately. Many NEDs commit themselves for about 20 – 30 days a year with a company, and the rest of their time is spent in other jobs or on other appointments. Individuals holding a large number of NED positions are unlikely to contribute effectively to them all. (As a counter to this argument, it could be suggested that when NEDs are appointed, they should be asked to agree to a minimum number of days that they will commit to the company each year.)
- It has been argued that in many companies NEDs are inclined to rely on the opinion of executive directors, and that the influence of senior executive directors is therefore sometimes much greater than it ought to be, and decision-
making by the board may be dominated by the executives. The tendency to agree with the opinions of executive directors may be reinforced by the fact that the law makes no distinction between executive and non-executive directors, and NEDs may be worried about the legal implications of making bad decisions. It is safer to agree with the executive directors who should ‘know best’.

- NEDs often come from the same ‘background’ as their executive director colleagues, and many are executive directors of other companies. Although cross-directorships should be rare, there is a tendency for NEDs and executives to consider themselves as ‘members of the same club’. There is a ‘you scratch my back and I’ll scratch yours’ mentality, and NEDs may not challenge their executive director colleagues too aggressively. NEDs may therefore fail in their role of ‘monitoring’ the executive management.
- The recommendations of the Tyson Report could be mentioned. Companies should try to recruit NEDs from a wider pool of potential candidates.
- It has also been argued by some entrepreneurial businessmen that NEDs can slow down the process of making business decisions. However, a function of NEDs is to ensure that major decisions are taken after due consideration, and should not be taken quickly, at greater risk, by senior executives.
- It has been argued that NEDs should help to make the board more accountable to shareholders, but in practice they rarely meet with shareholders. (The Senior Independent Director may be an exception.) A counter to this argument is that the Chairman of the board should be responsible for making NEDs fully aware of the views and opinions of the major shareholders.
- A good answer would end with a summary and overall assessment. Views about NEDs will inevitably differ. One view may be that there are valid criticisms of NEDs, but measures can be taken to deal with the problems. On balance, NEDs do appear to fulfil the role for which they are intended – to bring balance to the board and contribute to strategic policy decision-making.

**EXAMINER’S COMMENTS**

A key element of a good answer to this question was to present arguments in a critical, but balanced fashion. Many candidates suggested that a major criticism of NEDs was their lack of independence. There is certainly a problem that over time a NED who was independent when appointed may gradually lose this independence. The Combined Code suggests that an NED who has been in office for nine years or more is unlikely to be independent. However, candidates pushed this argument to the limit, suggesting that many NEDs are not independent when appointed. In some countries, where governance is weak (for example India), this may be true. However it should not be the case with public companies in the UK, where the independence of NEDs is closely monitored by institutional investors.

In general however, as indicated earlier, this question was well answered.

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.