CORPORATE GOVERNANCE
NOVEMBER 2009

SUGGESTED ANSWERS AND EXAMINER’S COMMENTS

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

Once again, the standard of answers by candidates ranged enormously. Some candidates were clearly better prepared than others for the examination.

Some general points can be made about answers by candidates. Some of these have been made in the past, in comments on previous examination papers.

(i) In Section A, there are 10 questions each worth 4 marks maximum. In Section B, each question is worth 20 marks in total, but most questions were divided into two or three parts, each with an allocated maximum number of marks. Some candidates wrote well over one page, sometimes over two pages, on answers to parts of Section A, but wrote just a few lines on Question 2(b) (worth up to 10 marks) and little more than a page on other Section B questions. Candidates should allocate their time sensibly, with about 1.5 minutes for each mark, giving 30 minutes for reading time and answer-planning time.

(ii) In spite of comments in the past about the dangers of writing lists of brief bullet points, many candidates used them again. If a point is not made clearly and in full by a candidate, full marks will not be awarded. Candidates do not get credit for leaving it to the marker to ‘fill in the gaps’ that they have not been written about. Brief lists of bullet points in an answer read like a hasty list of incomplete notes. In commenting on the previous examination in November 2008, I wrote: "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 explain sufficiently 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.” This comment still applies.

Of the Section B questions, Question 2 and Question 5 appear to have been the most popular. Unfortunately, Question 2 was answered the most badly. Some candidates were unable to explain properly why the roles of the chairman and CEO should be separated and then went on to make unrealistic and impractical suggestions and recommendations. It
appeared some candidates were unprepared on basic elements of company law as well as issues of corporate governance.

SECTION A
(Compulsory – answer all parts of this question)

1. (a) Summarise the statutory duties of directors as specified by the UK Companies Act 2006. (4 marks)

SUGGESTED ANSWER

Seven statutory duties are set out in sections 171 – 177 of the Companies Act 2006. Directors are required:

(i) To act within their powers.
(ii) To promote the success of the company.
(iii) To exercise independent judgement.
(iv) To exercise reasonable skill, care and diligence.
(v) To avoid conflicts of interest.
(vi) Not to accept benefits from third parties.
(vii) To declare any interest in a proposed transaction or arrangement.

EXAMINER’S COMMENT

A large proportion of candidates did not appear to know anything about the 2006 Act and directors’ statutory duties, and wrote instead about fiduciary duty (which is not in the Act) and often guessed incorrectly at what the other duties might be.

However, a large proportion of candidates identified all or most of the statutory duties, and scored well on this question.

(b) The UK Combined Code includes a provision relating to the annual review of performance of the board, its committees and its directors. Suggest ways in which the chairman might assess the performance of a non-executive director. (4 marks)

SUGGESTED ANSWER

• The Combined Code states as a principle that the evaluation of individual board members should consider whether the director continues to contribute effectively and continues to demonstrate commitment to the role.

• An assessment of individual directors is, therefore, likely to include consideration of:

  (i) Attendance at meetings of the board and board committees.
  (ii) Other time spent with the company or acting for the company.
  (iii) Contributions to discussions at board meetings.
(iv) Contributions to board committees: for example, the effectiveness of a board committee if the individual is its chairman.
(v) Continuing independence, if the individual is appointed as an independent non-executive director (NED).

- The chairman may also use the annual performance review to assess whether the individual NED should be recommended for re-election, and to discuss his views with the chairman of the nominations committee.

**EXAMINER’S COMMENTS**

Many candidates provided a good answer to this question, using knowledge of the topic and common sense to cover most of the key points.

(c) **Outline four circumstances where a non-executive director would not be considered to be an independent director.**

(4 marks)

**SUGGESTED ANSWER**

The suggested answer below is based largely on the Higgs Guidelines and Combined Code, and was the basis for answers by all candidates.

- According to Higgs, deciding whether an NED is independent is largely a matter of judgement by the board. This judgement will be influenced by views of the NED’s character and experience.

- The independence of an NED is usually questionable in the following circumstances:
  
  (i) The director has recently been an employee of the company.
  (ii) The director has a material business relationship with the company.
  (iii) The director receives remuneration from the company in addition to his/her annual fee.
  (iv) The director has close family ties with other directors or the company’s advisers or senior executives.
  (v) The director represents a major shareholder.
  (vi) The director has served on the board for 9 years or more.
  (vii) There is a cross-directorship involving the director.

**EXAMINER’S COMMENTS**

Many candidates were familiar with this topic and provided four circumstances where a NED is not usually considered independent.
(d) Outline the main principles with regard to the rights of shareholders in the OECD Principles of Corporate Governance. (4 marks)

**SUGGESTED ANSWER**

- The corporate governance framework should protect and facilitate the exercise of shareholders’ rights, such as:

  (i) The right to secure methods of ownership.
  (ii) The right to transfer shares.
  (iii) The right to obtain timely and relevant information.
  (iv) The right to vote in shareholders’ meetings.
  (v) The right to elect members of the board of directors.
  (vi) The right to share in the profits of the company.
  (vii) The right to participate in major changes in the company, such as a change in its constitution and the issue of new shares.

- The rights of shareholders in takeovers should be protected.

**EXAMINER’S COMMENTS**

A few candidates confused the rights of shareholders with equality of treatment of shareholders. However, many candidates answered this question well, identifying a suitable number of rights that are set out in the OECD Principles.

(e) Distinguish between the responsibilities of the board of directors and the external auditors for the discovery of fraud within a company. (4 marks)

**SUGGESTED ANSWER**

- The directors and management of a company are responsible for safeguarding the assets of the company. As part of this responsibility they are responsible for preventing fraud and detecting fraud if it occurs.
- The prevention and detection of fraud is achieved through a system of internal control and internal controls. The board is responsible for the effectiveness of the internal control system.
- The external auditors are responsible for giving an opinion to the shareholders about whether the financial statements give a true and fair view. They have no specific responsibility for detecting fraud.
- However, if a material fraud has occurred, the auditors do have some responsibility for detecting it and would be expected to identify some fraud in the course of their audit if they carry out their work in a professional and competent manner.
EXAMINER’S COMMENT

Many candidates did not seem to be properly aware of fraud, and what it is. In their answers, they discussed the responsibility of the board of directors for producing financial statements that give a true and fair view of the company’s performance and position. Although there could be deliberate fraud in reporting by the directors, fraud refers much more generally to criminal activities by employees and others that result in losses to the company. The board of directors is responsible for safeguarding the assets of the company, and as a consequence, have a responsibility for preventing fraud or detecting it when it happens. The internal control system should include controls that prevent or detect fraud. Too many candidates did not appear to understand this.

(f) What are the main benefits of electronic communications between a quoted company and its shareholders? (4 marks)

SUGGESTED ANSWER

Answers to this question could have defined what ‘electronic communication’ means. It should have been recognised that it consists mainly of e-mail and use of the company’s web site.

Answers should also have recognised that communications may be in both directions – from shareholders to the company as well as from the company to shareholders.

Answers may have included the following benefits:

- Electronic communications are less costly than communicating in hard copy.
- There may also be environmental benefits for large companies with many shareholders (less wastage of the product of natural resources such as paper).
- Electronic communication is quicker and probably more reliable than sending information by post. When communication is by post there is a problem that items may be lost or sent to the wrong individual in an organisation.
- Information sent electronically is more likely to be seen by the key decision makers within large investor institutions, rather than more junior employees.
- This may improve the probability that shareholders will participate in decision-making by submitting proxy votes.
- When information is posted on a company’s web site, it is easily accessed by anyone. This is not the case when items are printed and sent by post.

Other valid ideas were accepted.

EXAMINER’S COMMENT

This question asked for an explanation of the main benefits of electronic communications. Far too many answers described what electronic communications makes possible, without explaining what the benefits were. A popular comment was that electronic communications are fast and ‘timely’: there were no explanations of why speed in sending out company information is a benefit, and no explanations of what
‘timely’ means - in time for what? There were also comments that electronic communications are ‘effective’ and ‘efficient’, with no explanation of what this means.

Other suggestions were that electronic communications improves dialogue between a company and its shareholders, without making it clear how or what the answer intended. Superficial comments such as these lack conviction.

However, better candidates dealt with this question well, showing good awareness of the benefits of electronic communications for foreign shareholders and the benefits of using the company’s website.

(g) Explain briefly the reasons for the development of corporate governance-type guidelines for entities in the voluntary sector, such as charities.

(4 marks)

SUGGESTED ANSWER

(i) The voluntary sector has responded to the growing interest in corporate governance generally, initially in companies and the public sector. Interest in corporate governance for the public sector has increased as the size of organisations in the sector has grown.

(ii) The governance initiatives are also in response to a perceived decline in public confidence in the sector.

(iii) There is competition for funding, and it is thought that the best-governed charities will attract funding more successfully.

(iv) There has been a lack of clarity about the duties and liabilities of board members, such as charity trustees in the UK. Governance guidelines provide more clarity.

(v) The demand has grown for the accountability of charities to beneficiaries and donors, particularly with regard to the amount of funds spent on administration. The demand for accountability is linked to a requirement for greater transparency.

Comments would also have been accepted about initiatives such as changing methods of selecting board members for charities and other voluntary organisations, greater reporting requirements and greater clarity about governance structures.

EXAMINER’S COMMENT

Many candidates failed to provide answers to the specific question, discussing why corporate governance in the voluntary sector is a ‘good thing’, whereas the question asked about the reasons for the development of governance in this sector. This is not quite the same thing. Candidates should always be aware of how they are answering the actual question that has been set.
(h) Why should a remuneration committee use inter-company comparisons with caution when deciding on the remuneration for senior executives? (4 marks)

**SUGGESTED ANSWER**

- The most important concern about using inter-company comparisons to decide on pay for senior executives is that there may be a tendency to ‘ratchet upwards’ the general level of remuneration settlements. Smaller companies may offer remuneration packages to match those offered to executives in larger companies, and larger companies respond by improving their remuneration terms too.
- Executives may use inter-company comparisons to argue for higher remuneration or better incentives. A remuneration committee should be wary of this argument, which would be a negotiating ploy.
- Remuneration for senior executives should not ignore the general level of remuneration for other employees within the company. Executives should not expect high remuneration when other employees receive poor remuneration.
- In the case of performance-related pay, it can be difficult to compare incentives between different companies because the nature of an incentive depends, to a large extent, on how easy the targets may be to achieve. This in turn depends largely on the current commercial and financial position of the company and its future business prospects – these differ widely between companies.
- Regardless of what other companies pay their top executives, a company should not provide executives with entitlements to rewards that are not justified by performance.

**EXAMINER’S COMMENT**

Many candidates began their answers by explaining why companies use inter-firm comparisons when deciding a level for senior executive remuneration, and some even discussed why this is beneficial. The question was asking why inter-firm comparisons should be used with caution, not why they happen or why they are useful. Other candidates wrote about the need for companies to pay what they can afford, without recognising that in order to attract and retain top executives, it is necessary to offer a package that compares adequately with the packages offered by other companies.

(i) What information should be contained in the business review of a quoted company within the European Union? (4 marks)

**SUGGESTED ANSWER**

The requirements relating to the contents of a business review vary between countries in the European Union and the size of company. In the UK, the requirements for quoted companies, to the extent necessary for a proper understanding of the performance and financial position of the company, are that the business review should contain:
• The performance of the company in the year just ended and its financial position at the end of the year.
• Information about the main trends and factors likely to affect future development and performance.
• An explanation of the main risks facing the company.
• Information about environmental matters, the company’s employees and social and community issues.
• Information about any individual or entity with which the company has a contractual relationship which is ‘essential’ to the business of the company.
• An analysis of the development, performance and position of the company using key financial performance indicators.
• An analysis using other non-financial performance indicators where appropriate.

Disclosures are not required of future developments that, in the opinion of the directors, would be seriously prejudicial to the company’s interests.

EXAMINER’S COMMENTS

Some candidates seemed to assume that the business review is the same as the directors’ report. (It is contained within the directors’ report). They consequently referred to items that should be in the directors’ report but are not part of the business review. However, those candidates who knew what a business review was, were able to identify much of the information it should require, and consequently were awarded a good mark.

(j) What are the main disadvantages in using share options (stock options) as an incentive in the remuneration package of senior executives of quoted companies? (4 marks)

SUGGESTED ANSWER

• Share options may focus the interests of executives on the share price, to the point where the directors prefer to retain profits for reinvestment and future profits growth, and limit dividend growth. This may be against the interests of shareholders.
• Share price movements can be unpredictable, and there is a risk that executives will be over-rewarded by options if the share price rises temporarily without good reason.
• If the share price falls below the option exercise price, and are ‘under water’, they may cease to provide an incentive to the option holders. This does not happen with share award schemes.
• If options are under water, executives may negotiate the cancellation of existing options and issue of new options at a lower exercise price. If so, this means that the interests of shareholders and executives are not properly in alignment.
• The award of share options may eventually risk an excessive dilution of earnings per share for existing shareholders.
• However, it is now a requirement that the cost of share option schemes should be included as an expense in the company’s annual income statement. This was
not the case some years ago. It makes option schemes less attractive because they reduce reported profits.

- Executives may be more attracted by short term incentives (such as cash bonuses for meeting annual targets) and so give more importance to short-term performance than to longer-term performance.
- Executives receiving an award of options for the first time may benefit from a ‘legacy effect’ of their predecessors – the future growth in profits and the share price may be due to the performance of the predecessor. The ‘wrong person’ is therefore rewarded.

**EXAMINER’S COMMENT**

A remarkable number of candidates did not appear to know what options were or how option schemes work. Many criticised them for being short-term in nature. Although candidates might feel that three years or longer is not ‘long term’, companies do not think so. Many shareholders do not retain their shares for three years. A number of candidates stated that option schemes encourage executives to act criminally and engage in insider dealing – it would be interesting to know who they had in mind when they wrote this.
2. Several years ago Kantoria plc, a UK listed company, suffered a large fall in annual profits. A new Chief Executive Officer (CEO) was appointed. He was very successful in restoring the profits of the company and gained a reputation as a top-class businessman.

The chairman of the company retired recently and the CEO was invited to become the new chairman whilst retaining his position as CEO, in contravention of ‘best practice’ in corporate governance. The company explained its non-compliance to investors by stating that there was no individual better qualified for the role of company chairman, and that in spite of its best efforts the nominations committee had not yet identified a suitable successor as CEO.

As company secretary of Kantoria plc, you are aware that several major shareholders are angry about this arrangement, and expect it to be temporary so that the best standards of corporate governance are maintained. They have written a joint letter of protest to the board of directors.

(a) Explain why it is best corporate governance practice that the roles of CEO and chairman should not be held by the same individual. (5 marks)

SUGGESTED ANSWER

Answers were expected to cover the following points, or something similar. Recommendations and suggestions should have been sensible and, where necessary, suitably justified or explained.

(i) The two roles should be held by different individuals so that no individual on the board has ‘unfettered power’. The chairman is responsible for leading the board and the CEO is responsible for leading the executive management. Combining the two roles creates a position of dominant power.

(ii) They are two different roles, requiring different sets of skills. The same individual may not have the set of skills required to perform each role well.

(iii) When an individual has a dominant position on the board, there is a risk that the board will lose the balance that is required, and NEDs might not be able to contribute as effectively as they should.

(iv) In some cases, there may be a risk of the chairman/CEO being a domineering personality, who disregards the views and opinions of board colleagues.

(v) The need for a division of the two roles is sufficiently important that the roles of each position should be set out in writing and agreed by the board.
(vi) It is also recommended (UK Combined Code) that the CEO of a company should not go on to become its chairman even if he or she gives up the position as CEO.

(vii) The UK Combined Code also recommends that the chairman should be independent at the time of his appointment, and this is not possible if the person appointed is the current or former CEO.

(b) **Suggest the measures that you would recommend in response to the protests from the major shareholders about this arrangement in Kantoria plc.**

(10 marks)

**SUGGESTED ANSWER**

(i) There should be a response to the shareholders, and the chairman/CEO will be aware of the dissatisfaction. The company secretary would be well placed to help with efforts to resolve the problem.

(ii) It should be suggested that in view of the opinions of some shareholders, the senior independent director (SID) should be asked to get involved. The SID should become an alternative channel for shareholder complaints.

(iii) The SID should also establish how many shareholders are dissatisfied with the combination of the CEO/chairman roles, so that the scale of the potential problem can be fully assessed. It may also be appropriate for the SID to discuss the issue with representatives of the investment institution’s representative bodies.

(iv) The SID will be expected to act as a forceful contributor to the work of the board, providing some counter-weight to the ‘power’ of the CEO/chairman.

(v) It is unacceptable that the roles of chairman and CEO should be combined for more than a short period, perhaps a few years at most. A succession strategy must be considered. Although the SID may be involved, together with the chairman/CEO, in initiating this, the task of finding one or more suitable successors belongs to the nominations committee.

(vi) The nominations committee should be asked to consider the problem of succession, and ways of finding a suitable successor as CEO. The committee may also need to consider whether it will be appropriate to retain the former CEO/chairman as chairman after a new CEO is appointed.

(vii) Key shareholders should be kept informed about the board’s plans for succession.
(viii) Since the company is in breach of the Combined Code provisions, the reasons why the same individual is both chairman and CEO should be clearly explained in the annual report and accounts of the company.

(c) Discuss the measures that the shareholders might take if their demands for the separation of the roles of CEO and chairman are not satisfied.  

(SUGGESTED ANSWER)

(i) If the shareholders wish to take action, beyond discussing their concerns with the chairman/CEO and SID, they should formulate a co-ordinated plan of action. Acting individually, they are unlikely to have much effect with any action they take. The representative bodies of the investment institutions may also give guidance to members, particularly on voting issues at the Annual General Meeting (AGM).

(ii) Shareholders could try to use their votes at the next AGM to signal their strong dissatisfaction. One option would be to vote against the re-appointment of the SID or any member of the nominations committee who is standing for re-election.

(iii) If the concern of shareholders is so great that they are concerned about the future of the company (and its solvency), their action could be more forceful, perhaps with an initiative by a substantial group to call an Extraordinary General Meeting (EGM). This course of action would be extreme, and so is very unusual.

(iv) Shareholders may also be able to ‘embarrass’ the company with adverse publicity, by signalling their dissatisfaction to the press and other media.

(v) As an alternative course of action, any individual shareholder who remains dissatisfied could sell their shares.

EXAMINER’S COMMENT

This question was answered badly. Part (a) asked why the roles of chairman and CEO should normally be kept separate – a fairly basic corporate governance issue. Many candidates argued that if one person held both roles he would be domineering and run the company for his own personal benefit. Almost invariably, they then went on to contradict themselves by saying that combining the role is sometimes desirable, as in the case of Marks and Spencer. Combining the roles creates a dominant position of power and authority, and this leads on to some risk of a domineering personality and loss of influence of NEDs. But it is not inevitable.

Answers to part (b) were often impractical or unrealistic, and did not consider information given in the question. The question stated that the position of chairman had been offered to the CEO and that a search was under way for a new CEO. Many
candidates wrote about the need to find a new chairman, without explaining why this change of policy should happen. Other candidates argued that the CEO would have to be told that he could not become chairman, without considering how the CEO (who had contributed to the company’s success in recent years) would react on being told about this change of mind.

In general, answers to part (b) were narrow in focus, and discussed a limited range of issues – some candidates wrote exclusively about the need for dialogue between the company and major shareholders (without suggesting who should represent the company in these discussions), whereas others focussed exclusively on the need to find a new CEO (or chairman). Not enough candidates discussed the implications of the proposed changes for the balance of power on the board and the possible need for a strong SID or more independent NEDs. Some candidates suggested, correctly, that succession planning should be improved, but failed to understand that this was an issue for ‘next time’ and not a solution to the current problems. Quite a few candidates suggested that in the search for CEO (or chairman), the company should look beyond the ‘usual suspects’ at potential candidates in the ‘marzipan layer’. These were recommendations in the Tyson Report about the search for independent NEDs, not the search for a chief executive or a chairman.

In part (c), the most popular suggestions were that the shareholders should call an EGM, without considering the practical difficulties involved in this. Many others preferred to recommend that the shareholders should vote at the next AGM against the election of the chairman. However, the appointment of a chairman is not a voting issue at an AGM, and the CEO would only stand for re-election when (and if) he is required to retire by rotation. Another popular suggestion was that the shareholders should engage in ‘shareholder activism’, without suggesting what this meant in practical terms.

Taken as a whole, answers to this question indicated a failure to read the question properly and a lack of adequate thought, realism and answer planning.

Far too many candidates made assertions about the effect on the share price of shareholders buying or selling their shares. It is true that share prices move in response to buying and selling activities, in accordance with the law of supply and demand. However, if share prices fall too far, other investors will buy them because they see an opportunity for a good return. In the long run, share prices will move up or down with investor expectations. In this question, the share price would probably fall substantially only if investors believed that the company’s appointment of the CEO as chairman would have a damaging effect on the company’s future performance.

Although this question was answered badly in general, a few candidates provided a good answer. The best answers were those that demonstrated a practical approach to analysing the situation, and recognising that the company should try to respond to the legitimate concerns of the shareholders. Good answers also discussed both the problems of the nominations committee in finding a suitable external candidate for chairman and also the need for constructive engagement with the shareholders who had expressed their concerns. They also showed common sense by recognising that having
appointed the former CEO as chairman, the board could not now ask him to give up the chairmanship and revert to being the CEO again.

3. Dotterick plc is a large UK manufacturer of food products, with many well-known branded products. It imports raw materials for its products from a number of developing countries, and all its manufacturing operations are based in the UK. It has entered into ‘Fair Trade’ agreements with suppliers of key commodities in some of these countries. These agreements contain an undertaking by the company to continue to buy products from approved suppliers at fair prices that will enable the suppliers to make a good profit and treat their own employees in a fair manner.

The company has been suffering from the effects of a severe economic downturn, although demand for its food products has not fallen as much as sales demand for non-essential consumer goods.

The CEO of the company has been speaking to some of the executive directors about changes that he wants to see introduced. He thinks that the economic recession will make all companies focus on profitability and that concerns about corporate social responsibility (CSR) will lessen. He has always held the view that CSR provided some public relations benefits but that it has no effect whatsoever on the financial performance of companies or their share price.

He believes that, when companies are making employees redundant, their stated concerns for CSR issues can be seen as “the pretence that they really are.” In response to a comment from the operations director about the value of sustainability reporting, the CEO replied that this type of reporting was unnecessary and without benefit.

(a) Discuss how you would respond to the views of the CEO that the concern shown by companies about CSR issues is primarily a public relations exercise. Your discussion should include consideration of how CSR initiatives by a large public company could contribute to the long-term benefits of the company. 

(10 marks)

SUGGESTED ANSWER

Answers to questions on CSR have a tendency to be rather simplistic and shallow. Credit was given to candidates who demonstrated a sensible analytical approach to this question.

Points that might be raised include:

(i) There is almost certainly some element of ‘public relations exercise’ in the CSR pronouncements of companies. Given sufficient publicity, CSR can enhance the reputation of a company with its potential customers and its employees in
particular. In the long run, this can have a beneficial effect on sales and also recruitment of staff.

(ii) However, the benefits are difficult to quantify. There is no convincing evidence yet of a close link between CSR and financial benefit.

(iii) In the case of this company, the fact that the CEO has expressed the views described suggests that the board of directors may consider CSR to be a matter of PR and marketing. His board colleagues may have different opinions.

(iv) The agreement with suppliers in certain developing countries is a potentially important commercial development, because it appears to be an attempt to secure long-term supplies of key commodities. It is a CSR initiative because it demonstrates concern for the well-being not only of supplier organisations (and treating them fairly) but also for the employees of those suppliers and, presumably, the communities in which they live. This seems to be a strategy with a strong CSR element that is in the long-term financial interests of the company.

(v) Concerns for matters such as suppliers, communities and employees may help to attract investments from ‘ethical investors’ – investment institutions that specialise in making investments in companies they regard as ethical in their behaviour and business activity. If so, this may have some effect in maintaining the share price.

(vi) It may also be argued more generally that the CEO appears to hold the ‘shareholder view’ of corporate governance – that the primary purpose of a company should be to maximise the profits of shareholders. This view may be challenged, for example, with the ‘enlightened stakeholder view’ – that even if the main purpose of a company should be to increase the wealth of shareholders, concern should be shown for other stakeholder groups such as employees, customers, suppliers and society as a whole.

(vii) An enlightened stakeholder view is not inconsistent with a policy, in the short run, of making some employees redundant because the company is not making enough profit to support such a large workforce. However, in reducing the workforce the company should consider its longer-term employment needs and try to avoid losing skilled staff that it will need again when (and if) a business recovery comes.
(b) **Explain the purpose and benefits of ‘triple bottom line reporting’.
(10 marks)**

**SUGGESTED ANSWER**

Points that might be raised include:

(i) The nature of triple bottom line reporting, a form of sustainability reporting, is to provide information about three aspects of a company’s performance: financial, social and environmental.

(ii) Triple bottom line reports may include some narrative, but an important aspect of the reports is to present quantified information about performance in relation to certain key performance indicators (KPIs) in each of the three areas.

(iii) Actual performance for each KPI is compared with the previous year’s performance, or against targets for achievement, or both.

(iv) Like all reports, the purpose of triple bottom line reports is to present information to an identifiable readership. The reports are prepared for a wider audience than the company’s shareholders, although a company will probably choose to send a copy to each shareholder.

(v) A triple bottom line report demonstrates to stakeholder groups that the company is aware of targets that it needs to achieve in social and environmental areas, as well as the need to achieve good financial performance. By presenting performance in all three areas in a single report, the company is demonstrating that it considers that achievement targets in these areas should not be inconsistent with each other. This has important CSR implications.

(vi) Because much of the information in the reports is quantified, it is also possible to have the reports audited by an independent expert auditor. Audited reports may help to make them more ‘believable’. They should also help to establish a ‘sustainability’ reputation for the company, which in turn may have long-term benefits.

(vii) Triple bottom line reports help to draw the attention not only of shareholders and other external stakeholders to the financial and CSR achievements of the company, but also to its management. Management should be made more aware, through the preparation and publication of these reports, that the company has a variety of targets, both financial and non-financial, and that these are not necessarily inconsistent with each other.

(viii) In the EU, quoted companies are required to publish narrative reports that cover, amongst other things, key social and environmental risks. However, business reviews are not required to present all the information that triple bottom line reports contain. Triple bottom line reports are, therefore, supplementary to business reviews.
EXAMINER’S COMMENT

In answer to part (a), many candidates stated superficially that CSR ‘ensures’ the long term success of a company by attracting investors and so pushing up the share price. Interestingly, no candidates could give an example of companies that have benefited in this way. Many candidates also stated how CSR policies would make more customers buy the company’s products and make employees much happier and (presumably) more efficient or effective in their work. Superficial statements like this are not worth much, and are hardly convincing. The question gave some hints in the scenario, referring to fair trade supplies and the possible need to make some employees redundant: only a small proportion of answers made reference to the scenario at all.

Many candidates wrote that the CEO in the question was wrong to argue that CSR is concerned mainly with public relations, and then went on to discuss how CSR is important for reducing reputation risk, without recognising the link between reputation and public relations. This suggests that many candidates had not spent much time during their studies thinking about CSR issues and developing their own well-argued views.

A few candidates wrote about the benefits of CSR reporting, whereas the question was about CSR itself, not reporting it.

The best answers recognised that there is a link between public relations and reputation, and commented on specific issues raised in the scenario – the fair trade agreements with suppliers and how CSR policies can be applied at a time when the company is making employees redundant. One or two candidates even took up the point, hinted at in the question, about whether there is or should be any relationship between CSR and company profitability and the share price. In questions with a scenario, there are often strong hints about issues to discuss that will earn marks.

Part (b) asked about the purpose and benefits of triple bottom line reporting. A significant number of candidates did not know what triple bottom line reporting was, and consequently provided answers that were off target.
4. You are the secretary of a medium-sized listed company. The company has recently appointed a new chairman of the audit committee, who has been asked by the chairman of the board of directors to organise the board’s annual review of the system of internal control. Having been appointed only recently, the audit committee chairman does not fully understand why the review is necessary, or how it should be carried out. He is aware that the company is expected to follow the Turnbull guidelines in carrying out this review. He thinks that you will be able to provide him with useful information and offer some advice.

(a) Explain the meaning of ‘effectiveness’ with regard to a system of internal control. (5 marks)

**SUGGESTED ANSWER**

Internal control refers to a control system within an organisation that should prevent errors (or fraud) from happening, and if they do occur, to identify them and initiate corrective action.

In some countries, the internal control system relevant to corporate governance is the system of financial control only (for example, the United States). In other countries, internal control refers to systems of financial control, operational control and compliance control (e.g. United Kingdom).

‘Effective’ means that the control system is successful in its purpose – of preventing and identifying errors to a suitable extent. (It is impossible to prevent and detect all errors.)

Answers may have referred to the fact that a system of internal control consists of a control environment, a system of risk identification and assessment, a system of information and communication for the control system, internal controls, and a system of monitoring the effectiveness of the system (as defined by COSO and Turnbull).

(b) Discuss the reasons why a review by the board of the effectiveness of the internal control system should be an important element of a system of corporate governance for listed companies. (7 marks)

**SUGGESTED ANSWER**

- It should be remembered that in the past, when some major companies have collapsed, poor and ineffective controls have usually been a factor in the collapse.

- Shareholders are the owners of a company, but are in no position to control the risks that are taken on their behalf by the company’s management. Shareholders need to be informed that the risks in their investment are effectively controlled.
• The board of directors is accountable to the shareholders, but as a board they are not directly involved in the design and implementation of the control system and its controls. This is the task of management.

• The board should, therefore, carry out a regular (annual) review of the system of controls, to satisfy itself that management are fulfilling this aspect of their responsibilities well, and so that they can report accordingly to the shareholders.

(c) **Suggest measures that might be taken by the audit committee, on behalf of the board, to carry out a review of the effectiveness of the system of internal control.**

*(8 marks)*

**SUGGESTED ANSWER**

Although the audit committee may perform much of the work for the board, the board as a whole is responsible for the statement about internal control to shareholders in the annual report and accounts.

The review may be conducted each year, but the information needed to carry out the review should be gathered throughout the year. It is not clear in this case that the audit committee will have all the information it needs for a proper review.

The board/audit committee cannot satisfy itself that the control system is effective simply because there are controls ‘embedded’ within the system. It must also establish to its satisfaction that those controls are working as intended.

The information to carry out an assessment should be gathered throughout the year, in a series of formal reports plus one-off reports. Formal reports may be presented by management and ‘one-off reports’ may be prepared for the audit committee by the internal audit department.

In addition, the external auditors prepare a letter for management setting out weaknesses that they have found in the company’s internal financial controls. The board/audit committee should receive a copy of this letter, together with information from management about what has been done (if anything) to correct the weaknesses.

There should be a formal and defined process each year for carrying out the review of the effectiveness of the internal control system. The assessment should consider in particular:

(i) Changes in significant risks facing the company since the previous annual assessment, and whether these risks are suitably controlled.
(ii) The scope and quality of the monitoring of controls by management.
(iii) The frequency of reporting by management to the board about internal control.
(iv) The incidence of any significant failings or control weaknesses during the year.

A draft of the statement to shareholders should be prepared and discussed in detail by the board, before approval for publication.
EXAMINER’S COMMENT

Many candidates earned a reasonable mark in part (a) by saying that an internal control system is effective if it does what it is intended to do, which is to manage internal control risks. There were also many good answers to part (b), and answers discussed what might be the consequences for corporate governance if the internal control system was not effective.

Part (c) was the main problem for candidates. An audit committee is required to review the systems of internal control and risk management, and the question was asking how the committee might set about this task. In other words, if you were a member of an audit committee, possibly with relatively little accounting experience or knowledge, how would you expect your committee to carry out its responsibilities? The practical suggestion is that the committee should arrange for information to be provided from various sources so that it can carry out a review. Far too many candidates suggested that committee members should do the detailed investigations themselves.
5. The UK Combined Code on Corporate Governance gives explicit recognition of the corporate governance role of the company secretary.

(a) Discuss the responsibilities of the corporate secretary for corporate governance matters, as derived from the UK Combined Code or any similar national code of corporate governance. (16 marks)

**SUGGESTED ANSWERS**

The company secretary may perform any of the following tasks or responsibilities. These are set out in bullet point format.

**General**

- The company secretary should be responsible for advising the board (through the chairman) on all governance matters.

**Board Procedures and Composition**

- He should establish a summary of matters that are reserved for decision-making by the board.
- He assists with the preparation of agendas for meetings of the board and its committees, and ensures that papers are delivered to directors in good time and that minuted decisions by the board are ‘properly actioned’.
- He should ensure that the composition of the board continues to comply with governance guidelines. He should also support succession planning and ensure that there is suitable director rotation.
- He may arrange suitable directors’ and officers’ liability insurance.

**Board, Information, Development and Relationships**

- The UK Combined Code states that the company secretary, under the direction of the chairman, should be responsible for ensuring good communication flows within the board and its committees, and between executive management and non-executive directors.
- Also under the direction of the chairman, the company secretary should facilitate induction of new directors and assist with professional development as required.
- He should establish himself as the first person that NEDs should approach for advice and he should be proactive in providing advice and support to board members.
- He should help to develop and support annual performance evaluations of the board.
- He should arrange for major shareholders to meet with new NEDs, if they wish to do so.
Remuneration

- He should ensure that the members of the remuneration committee are familiar with governance principles (and the law) on remuneration.
- He should ensure that awards of shares or options, and the remuneration arrangements for NEDs, do not breach corporate governance rules or guidelines.
- In the UK, he should contribute to the drafting of the directors’ remuneration report and should ensure that any proposed new long-term incentive scheme is submitted to the shareholders for approval.

Audit and Internal Control

- He should be able to advise on the application of the guidelines on board review of the effectiveness of internal control.
- He may be required to ensure the effective operation of the whistle blowing system established by the company.

Relationships with Shareholders

- He should ensure that the board keeps in touch on a continual basis with the opinions of shareholders.
- He should manage investor relations on governance matters.
- He should help with the convening and management of the AGM and any other general meetings.

Disclosure and Reporting

- He should ensure that the company complies with the regulations or guidelines on reporting and disclosures on governance matters.
- He may be responsible for the part of the company’s website that deals with governance issues.

Directors’ Duties

- He should implement procedures to make sure that directors are aware of their statutory duties and that they comply with them.
- He should also implement procedures relating to disclosure of dealings by directors in the shares of the company.

Other responsibilities could have been included in the list, such as responsibility for the release of information to the stock market and the verification of published information before it is actually published.
(b) Suggest why this corporate governance role should not be performed by the company’s in-house lawyer. (4 marks)

SUGGESTED ANSWER

(i) A company solicitor is responsible for providing legal advice to the board on legal risk issues (the risk to the company from the consequences of breaking the law or other regulations).

(ii) Directors and senior managers may need to consult with the company lawyer about matters where there may have been some breach of the law in relation to governance.

(iii) In such cases, it would be difficult for the lawyer to be independent and act as the ‘conscience of the company’ about proper governance procedures, because it may deter directors and managers from consulting with him in his role as lawyer.

(iv) In the UK, the Law Society has recognised that company lawyers are not the persons best suited to act as the ‘enforcer’ of corporate governance within the company, even though they will inevitably become involved in governance issues on occasions.

EXAMINER’S COMMENT

Part (a) of the question asked for a discussion of the responsibilities of a company secretary for corporate governance matters. Many candidates provided a list of the role of the company secretary, without making any distinction between responsibilities of a governance nature, and those that might seem more administrative in nature such as arranging meetings, taking minutes, filing returns to the Registrar and keeping the company seal. It could be argued that organising board meetings and AGMs is an activity with governance aspects or implications, but this should have been made clear in any answer. Many candidates wrote that the role of the company secretary was ‘pivotal’ and that the company secretary was the ‘conscience of the company’, without attempting any explanation of what was meant.

The best answers identified a number of responsibilities of a company secretary, explained them briefly but in sufficient detail, and made it clear why those specific responsibilities related to corporate governance issues.

In part (b), many candidates chose to state that an in-house lawyer could not perform corporate governance functions because he did not have the knowledge or skill, or did not have enough time to do the work, or was not invited to board meetings. These are hardly convincing or sensible arguments and did not get any credit. Lawyers are skilled professionals, capable of learning new responsibilities and finding time for them, and anyone can attend a board meeting if invited.
6. In 2008, the global financial markets were devastated by the collapse of several major commercial banks and investment banks. Some banks were in such serious financial difficulty that they had to be rescued by the government, or taken over by another bank. There were many different views and opinions about who or what was to blame for the crisis, but many commentators agreed that senior bankers had not recognised the signs of trouble before it was too late.

When companies collapse, there is often evidence of poor corporate governance.

REQUIRED:

Discuss the ways in which the difficulties of the banks and financial markets in 2008 may have been attributable to weak or inadequate corporate governance.

(20 marks)

SUGGESTED ANSWER

The purpose of this question was to test the ability of candidates to relate issues of corporate governance to ‘real world’ incidents, and to show their understanding of how corporate governance issues are relevant to the successful conduct of business. There is no ‘correct’ answer, in the sense that there has been no official review into the events in world banking in 2007 – 2009. However, candidates should be able to discuss how weak corporate governance may possibly have contributed to the problems of the banks. Poor corporate governance was by no means the only reason for the crisis, but it probably contributed. Marks were awarded for the depth and scope of analysis provided by candidates.

Points that might have been raised include:

- **During 2007 and 2008, a number of very well-established banks collapsed, in the US and Europe (including the UK) in particular. Some were nationalised or part-nationalised, some were taken over by other banks, Lehman Brothers collapsed entirely. Weak corporate governance may have contributed to the situation.**

- **In the UK, there were a small number of press reports about former bank employees who attempted to ‘blow the whistle’ on the actions of their seniors, but who were ignored. Whistleblowing procedures seem to have a poor track record for effectiveness, although it is by no means clear what might have happened if the allegations of some whistleblowers had been thoroughly investigated within the banks affected.**

- **It is a requirement of good corporate governance that the board of directors should review the effectiveness of the system of internal control (either financial control only or financial, operational and compliance control) and risk management. However, it is quite probable that, in some banks at least, the**
systems of control were inadequate for their purpose. Perhaps because of the complexity of many aspects of banking, the board of directors might not have had the knowledge or understanding to carry out a sufficient review, with the result that banks were exposed to excessive uncontrolled risk. It would certainly appear that not all banks were fully aware of the business risks that they were taking.

- It is possible that some banks were led by dominant chief executives or chairmen, and that the non-executive directors did not act sufficiently well as a counter-balance to the power and influence of the CEO. A consequence may have been that some banks pursued high-risk strategies without sufficient challenge from the NEDs. This also raises the question about how effective the annual performance evaluations of the NEDs were, and the assessment of what they were actually contributing to the board and its decision-making.

- If it is the case that some banks were led by over-powerful CEOs/chairmen, it is also possible that some matters that should have been reserved for decision by the board may in fact have been taken by executive management instead.

- There was also widespread criticism of the bonus arrangements for many banking employees, traders and senior managers as well as executive directors. The criticism was largely directed towards the short-term nature of many incentive schemes, and the view that directors and other employees were motivated by their incentive schemes to take excessive risks in order to improve short-term performance, without much concern for longer-term performance. There seems to have been no consideration of risk and risk control in the incentive schemes that operated.

- Transparency in financial reporting and other reporting is another aspect of good corporate governance. The financial statements of major banks are complex and difficult to understand even for many experienced investors. The lack of clarity and transparency in financial reporting may possibly have resulted in a situation where shareholders were not properly aware of the financial position of the banks and the security of their investment. The problem of insufficient transparency in financial reporting may have emphasised the need for supplementary narrative reporting (for example, a business review) for the benefit of users.

- The global economic recession that has followed the banking crisis appears to have raised questions generally about the most appropriate approach to corporate governance. ‘Traditionally’, there has been widespread acceptance of the shareholder approach or the enlightened shareholder approach to governance. There has been some argument that, in view of the short-term nature of much shareholding by professional investors, corporate governance should focus on the needs of stakeholders more generally, with less emphasis on shareholder interests.
EXAMINER’S COMMENT

This was the least popular question in Section B. Its purpose was to test the ability of candidates to recognise the various issues or problems in corporate governance – the role of the board (dominant leaders, ineffective NEDs), potentially misleading financial statements, involvement of shareholders, ethical behaviour (and, as some candidates explained well, occasional criminal behaviour), remuneration of senior executives, weaknesses in both risk management and internal control systems and (possibly) ineffectiveness of whistle blowing procedures. There was a lot to write about, and some candidates provided a good answer.

There were a few excellent answers. The best candidates discussed a range of corporate governance topic areas – the balance of the board and skills of directors, ineffective NEDs, dominance of some boards by powerful individuals, risk management weaknesses, internal control weaknesses, remuneration issues, lack of engagement with shareholders, ethical issues and possibly ineffectual whistle-blowing systems, and suggested how these issues may have featured in the problems experienced by the banks.

However, a common weakness was the use of unjustified assertions, such as statements that auditors were not independent and that financial statements were deliberately misleading. These are strong comments and need to be supported by logical arguments or examples.

Some candidates wrote about irrelevant issues such as the failure of the financial markets regulators. Some wrote about Enron and WorldCom, neither of them banks, even though the question was specifically about governance weaknesses in banks in 2008.

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.