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

It was encouraging to find that, in general, candidates appeared better prepared for the examination than in the past and, as a consequence, performed to a satisfactory standard or better. Putting in sufficient time to study remains the best way of performing well in examinations, whatever the subject.

However, some comments that have been made in the past continued to apply in this sitting, and it is worth repeating them. The comments do not apply to all candidates, but they do apply to a sufficient number to justify comment here.

(i) In answering Question 1, some candidates wrote at length about what appeared to be the topics they knew best. Although they usually scored well in these questions, they wrote more than they needed in order to earn the marks and consequently lost valuable time that could have been spent on other questions. In some cases, an answer to a 4 mark part of Question 1 was much longer than the answer to a 10 mark or 12 mark part of a Section B question. Candidates are strongly advised to be disciplined with their allocation of time to questions. This need for ‘time discipline’ will apply to the new examination structure as well as the old one.

(ii) A considerable number of candidates wrote parts of their answers, especially to the Section B questions, as bullet-point style brief lists. The points that were made consisted of perhaps three or five words only, and the candidate left it to the reader – the marker – to work out what point was being made. This technique is ineffective as the points that are made in an answer must be sufficiently clear. In commenting on previous examinations in November 2008, November 2009, and June 2010 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 is repeated here and still applies.

(iii) In the Suggested Answers for June 2010, a comment was made that care should be taken when using words like ‘ensure’. In this sitting, many candidates stated that an audit committee
'ensures' that the financial statements of a company give a true and fair view. It would be more accurate to comment that the audit committee reviews the financial statements that have been prepared, usually with the external auditor present at a final review meeting, and satisfies itself that the statements appear to give a true and fair view. The committee can then recommend the approval of the report and accounts to the board. This is prudent governance practice, but it does not ‘ensure’ anything.

(iv) A few candidates did not answer the actual question that was set, and instead wrote about the topic in general. This was particularly noticeable in answers to Question 5 on social and environmental reporting. Unless answers deal directly with the question, they are very unlikely to earn a good mark. This is why it is useful to spend a short time planning answers. By taking a short amount of time to think about what to write, candidates can check that they are thinking of relevant ideas – and also enough of them. Candidates are given full credit for relevant ideas that are clearly stated.

Of the Section B questions, Questions 2, 4 and 6 were the most popular. As indicated earlier, the general standard of answers was better than in the previous session, and much of the improvement was in the standard of answers to the Section B questions.

Note: Where applicable, the following answers refer to the UK Corporate Governance Code. Answers based on either the Combined Code on Corporate Governance or the UK Corporate Governance Code were accepted by the markers.

Section A

1. (a) Define ‘board balance’ and identify three ways in which board balance may be achieved.

   (4 marks)

   **Suggested answer**

   Board balance exists where no individual or group of individuals can dominate decision-making by the board of directors.

   Three ways in which board balance might be achieved include (any three of the following points were acceptable):

   (i) There should be a suitable balance of executive and non-executive directors (NEDs), particularly independent NEDs.
   (ii) The board should be of sufficient size that the balance of skills and experience of the board as a whole is appropriate for the needs of the business.
   (iii) The board should be of sufficient size that changes can be made to the composition of the board without undue disruption.
   (iv) There should not be any undue reliance on any particular individual, when deciding the chairmanship or membership of board committees.
   (v) The roles of the chairman and CEO should be kept separate, to prevent the creation of an all-powerful leader of the board.

   **Examiner’s comments**

   Many candidates answered this question well and, in general, this topic appeared well understood.
(b) Explain the nature of ‘agency costs’ according to the agency theory view of corporate governance, and outline each of the three elements or aspects of agency costs.

Suggested answer

Agency costs are a consequence of the separation of ownership (the shareholders) from control (the directors and management) in companies, and the conflicts of interest between them. Agency costs are the costs of having the directors (agents) make decisions on behalf of the shareholders of the company, instead of the shareholders taking the decisions themselves.

Agency costs have three elements:

(i) Costs of monitoring – The shareholders need to monitor what the directors are doing. (Monitoring costs include the cost of the annual audit.)
(ii) Bonding costs – Costs are incurred in providing the directors with a motive or incentive to act in the best interests of the shareholders. (Incentive arrangements in remuneration packages are intended to do this, but they have a cost.)
(iii) Residual loss – In spite of monitoring and incentivising, there will be occasions when the directors take decisions that are not in the best interests of the shareholders. (For example, they may pay too much for an acquisition that ‘destroys value’ rather than enhances it.)

Examiner’s comments

Many candidates provided a good answer to this question. Some candidates appeared not to know the three elements of agency costs, but earned reasonably good marks by explaining the general nature of these costs, and giving an example. Candidates who did not perform well on this question were those who did not appear to know much at all about agency theory.

(c) Giving your reasons, explain to whom the board of directors should report, and be accountable, in an enlightened shareholder approach to corporate governance.

Suggested answer

In an enlightened shareholder (or integrated) approach to corporate governance, the main objective of the company should be to benefit the shareholders of the company, but due consideration should be given to other stakeholders, such as employees and society in general.

(i) The board of directors should be accountable to the shareholders, and important ways of achieving accountability are through the audited annual report and accounts and the annual general meeting.
(ii) The board should also report to other stakeholders, but without being accountable to them for what they have done in the name of the company.
(iii) The board should not be accountable to all major stakeholder groups because this would spread accountability and have the practical effect of making the directors accountable to none of them.
(iv) The interests of the shareholders still predominate according to the enlightened shareholder approach, and there is accountability to the shareholders but not to the other stakeholders.

Examiner’s comments

Many candidates answered this question well. However, a common error was to assume in answers that accountability and reporting mean the same thing. Accountability is an important
principle in corporate governance and some candidates appeared unaware of its meaning. Some candidates referred to the King Report, which showed a good understanding of the topic.

(d) What do the OECD Principles of Corporate Governance state with regard to the treatment of minority shareholders and foreign shareholders? Give three examples of unfair treatment.

Suggested answer

All shareholders of the same class should be treated equally.

Examples of unfair treatment (by major shareholders or director/shareholders) include:

(i) Providing important information about the company to ‘local’ shareholders before it is sent to foreign shareholders. For example, by using the postal service to send out circulars instead of electronic communications.
(ii) Calling general meetings at short notice, giving foreign shareholders little time to arrange to attend or appoint proxies.
(iii) Making it difficult to appoint proxies for a general meeting.
(iv) Allowing takeover bids in which a higher price per share is offered to major shareholders than is offered to minority shareholders.

Examiner’s comments

Candidates, in general, answered this question reasonably well. Weak answers did not give clear explanations of examples of unequal treatment, but credit was given for any sensible idea.

(e) State four of the responsibilities of an audit committee with regard to the annual audit and the external auditors, as suggested by the Combined Code on Corporate Governance (now the UK Corporate Governance Code).

Suggested answer

Responsibilities of the audit committee with regard to the annual audit and the external auditors:

(i) Recommend to the board the appointment, re-appointment or removal of the auditors, for the board to recommend in turn to the shareholders at the AGM.
(ii) Approve the remuneration and terms of engagement of the external auditors.
(iii) Review the independence and objectivity of the external auditors.
(iv) Review the effectiveness of the annual audit process.
(v) Develop a policy on the allocation of non-audit work to the company’s external auditors.

Examiner’s comments

The question asked about the role of the audit committee with regard to the external auditors and the audit process, but a surprising number of candidates made points about internal audit and internal control, which were not relevant to this question. Some candidates gave the committee too much authority, suggesting that they negotiated the annual audit fee, decided whether to re-appoint the auditors and ensured the integrity of the financial statements.
(f) Suggest, giving brief reasons, whether it would be acceptable governance practice for the following types of non-audit work to be awarded by a listed company to its external auditors:

(i) Management consultancy services.
(ii) Book-keeping services.
(iii) Speaking as an expert witness for the company in a major legal case against a shareholder.
(iv) Tax advice.

(4 marks)

Suggested answer

The guiding principle should be that the external auditors should not be engaged to do non-audit work if this would threaten the independence of the audit firm in conducting the audit.

(i) Subject to the overriding principle of ensuring independence of the audit firm, it is acceptable to give management consultancy work to the auditors. The auditors are not required to check work done by the firm’s own staff, they are not required to make management decisions for the company and they would not act in a role of advocate for the company.

(ii) The audit firm should not be given book-keeping work because this would put the auditors in a position of having to check work done by the audit firm’s own staff.

(iii) The audit firm should not act as an expert witness for the company because it would be acting as an advocate for the company, and this could threaten its independence.

(iv) It is generally accepted that in most cases audit firms should be allowed to give tax advice to client companies, for the same reasons as in (i).

Examiner’s comments

Although the question dealt with a central theme in corporate governance, the quality of answers varied. Audit committees cannot make decisions about the allocation of non-audit work to the audit firm unless they are advised what is, and what is not, permissible. A lot of candidates did not appear fully aware of ‘the rules’ and what happens in practice.

(g) What rules apply to listed companies in the UK with regard to dealing by directors in shares of their company?

(4 marks)

Suggested answer

Dealing in shares of the company by directors:

(i) The law on insider dealing (in the UK, under the Criminal Justice Act 1993) makes it a criminal offence for an ‘insider’ to deal in shares of the company whilst in possession of price-sensitive information. This could make it illegal for a director to buy or sell shares in the company, for example, just before the company’s annual results are made public. The Financial Services and Markets Act 2000 also makes ‘market abuse’ an offence. The prohibition on insider dealing extends to any party who is related to a director.

(ii) The UK Listing Rules require companies to have rules on share dealing by directors that are at least as strict as the Model Code. The Model Code states that in normal circumstances a director must not deal in shares of the company during a close period (two months before the announcement of interim or final results for the year) or at any other time that he is privy to price-sensitive information. A director should also seek permission from the chairman (or another designated board member) before dealing in the company’s shares.
Examiner's comments

Many candidates provided satisfactory answers to this question. A common problem by some candidates was not distinguishing between the rules in the Model Code on dealings by directors in the shares of their company during close periods, and the broader statutory rules against insider dealing, and instead describing them as the same set of rules.

(h) Explain why and how induction for a new non-executive director might differ from induction for a new executive director who has been a senior executive with the company for several years.

(4 marks)

Suggested answer

Induction is the process of leading a newly-appointed director into his or her new role, and it is the way by which new directors familiarise themselves with the company and their responsibilities. A major difference between NEDs and executive directors appointed from within the company are that:

(i) The NEDs may know relatively little about the company, its business and its products.
(ii) Executive directors should know about many of the aspects of the company's operations (but not necessarily all of them), but may have no experience of acting as a company director.

Induction should be tailored to the requirements of each individual.

All new directors should be given some information about the composition of the board and issues that the board has been considering. Initially, this information may be provided by giving each new director a copy of the minutes of recent board meetings.

A NED may need to be made more familiar with the company, its business and its products, by means of site visits, meetings with key executives and other employees, and product demonstrations.

An executive director (and any non-executive without any previous experience as a director) may need information about the legal duties and responsibilities of directors, potential personal liability and the rules against dealing in the company' shares during close periods.

Examiner's comments

Most candidates appeared to understand the basic requirements of the question and provided basic answers. Very few candidates recognised in their answers that: (i) induction should be tailored to the needs of the individual, and these are likely to differ between individuals or (ii) that some information provided in the induction process is common to all directors, notably information about what the board has been doing. (New directors need to see the minutes of previous board meetings, but few answers included this.)

(i) How do the requirements for the annual board statement on internal control for a UK listed company differ from those for a company registered with the Securities and Exchange Commission in the USA?

(4 marks)

Suggested answer

The requirements for UK listed companies are not as demanding as the requirements for US companies.
UK

- The UK Corporate Governance Code (formerly the Combined Code) requires the board, at least annually, to review the effectiveness of the system of internal controls (financial, operating and compliance controls) and report to shareholders that it has done so.

- The Disclosure and Transparency Rules require listed companies to describe the main features of the internal control system in relation to the financial reporting process.

USA

- Registered companies in the USA must include a report on internal control over financial reporting in their annual report and accounts (but not on operational or compliance controls).

- This should set out:
  
  (i) Management’s responsibility for adequate internal controls over financial reporting.
  
  (ii) An assessment by management of the effectiveness of internal control over financial reporting.
  
  (iii) Disclosure of any material weakness that management has found.
  
  (iv) An accompanying attestation report from the company’s auditors.

Examiner’s comments

This question, in general, was not well answered as many candidates did not appear to know the Sarbanes-Oxley Act rules on internal control reporting. Some answers confused the rules on internal control with the rules on the accuracy of the financial statements. Also, a disappointing number of answers did not describe the UK rules on reporting either, indicating a surprising gap in the general knowledge level for this topic.

(j) Describe briefly the different ways in which a company protects the independence of (i) a non-executive director, and (ii) the chief internal auditor.

Suggested answer

NEDs are appointed on contracts typically three years in duration and are not company employees. The chief internal auditor is a full-time employee of the company. Their situations are different, and the nature of ‘independence’ therefore differs for each of them.

(i) Methods of protecting NED independence:

- Ensure independence on appointment using the criteria set out in the UK Corporate Governance Code (formerly the Combined Code).
- Appoint for a fixed term.
- Pay a fixed annual fee with no incentives based on company performance.
- The chairman should check the NED’s continuing independence annually as part of the annual performance review.

(ii) Methods of protecting the independence of the chief internal auditor:

- Appointment and dismissal should be approved by the audit committee.
- The audit committee should ensure that the head of internal audit has direct access to the board chairman and the audit committee, and is accountable to the audit committee (as well as reporting to a senior finance executive in the normal line reporting system).
- The audit committee should receive periodic reports on the work done by internal audit.
• At least once a year, the audit committee should meet with the head of internal audit, with no executive management.

Examiner’s comments

The answer suggested above contains more points than were required for answers in the examination, and it is a list of the various different ideas that could have been suggested. In general, candidates provided reasonable answers about protecting the independence of the NEDs, but a surprising number of candidates did not mention the independence of the chief internal auditor at all. Some answers suggested that the chief internal auditor should report to the board or the audit committee exclusively, which is not realistic or practical.

Section B

2. You are the company secretary of a successful UK listed company. As such, you give assistance and advice to members of the board on corporate governance matters. You have recently been consulted separately by the company chairman and one of the executive directors.

The chairman wanted to discuss succession planning. It has been suggested to him by one of the company’s major institutional shareholders that not enough succession planning has been done for non-executive directors (NEDs), and that the board should do something about this failure. However, the chairman is not sure why succession planning for NEDs should be necessary, or what measures should be taken to initiate a planning process.

The executive director wanted to discuss an invitation he had received from another large UK listed company to become one of their non-executive directors. He had spoken briefly to your company chairman, who had asked him to speak to you before the matter is discussed by the board. He is not sure whether he should accept the offer of the directorship, and he believes that there are various matters that he should consider first before reaching a view.

(a) Explain the reasons for succession planning for NEDs, and suggest what measures might be taken by the board and its committees to initiate succession planning for NEDs.

(10 marks)

Suggested answer

Answers were expected to cover the following points, or something similar:

(i) Answers may have begun with a brief definition of succession planning. It is planning for the eventual replacement of board members. Although commonly associated with planning for the succession of senior board members (particularly the chairman and CEO), succession planning is required for the entire board.

(ii) Succession planning is needed for NEDs because a company should seek to continually refresh the input that NEDs make to the board. Continual refreshment of the board is seen as an important requirement for good governance. When NEDs are first appointed, they should be told that their term of office may not exceed the initial three-year contract term.

(iii) The board should contain a suitable range of skills, knowledge and experience. As the company grows and develops, the range of skills and experience that it needs on the board is likely to change. These changing needs can be met by planning to change the composition of NEDs on the board.
(iv) The longer they serve as directors of the company, the greater is the risk that NEDs will lose their independence. Plans should be made to change the NEDs on the board before this risk arises.

(v) The responsibility for succession planning should be delegated to the nomination committee, which should make recommendations to the board.

(vi) The committee may use the services of a firm of head hunters. It should consider the recommendations of the Tyson Committee (UK, 2003) and search beyond the ‘obvious suspects’, and consider candidates with a variety of backgrounds (for example, academics and managers in the ‘marzipan layer’ of company organisation structures).

(vii) The committee should also plan the timetable for change, identifying when particular NEDs will be reaching the end of their current contract term and which should be told that they will no longer be required by the company. Arrangements for interviewing replacements can be timed to coincide with the departure of the current NEDs.

(b) Suggest the issues that the executive director should consider before deciding how he should reply to the offer of a position of NED in the other company.  

(10 marks)

Suggested answer

Answers were expected to cover the following points, or something similar. The individual should:

(i) First consider the reasons why the other company has asked him to become a NED and satisfy himself about his own suitability for the position. He would also need to know what committees of the board he might be asked to become a member of (and possibly chairman). Factors to consider therefore include:

- Whether he has the necessary skills and experience that the other company is looking for.
- Whether he meets the criteria for independence that the other company presumably expects.
- Whether there are any conflicts of interest, or whether any conflicts of interest could arise, between his position as NED of the other company and his personal interests or the interests of the company of which he is executive director.

(ii) Consider his availability. As an executive director of the company that employs him, he will need the consent of the board to take up the position. The other company should have indicated how much time (in days per year) he would be expected to dedicate to his role as NED. Factors to consider are therefore:

- Would he get the approval of his current board for him to accept the position?
- Would he be prepared to, and would the board allow him to, devote as much time to the role as the other company would want?

(iii) Consider the fee that is being offered, and whether he would be allowed to retain this or would be required to hand it over to the company that employs him. He needs to be satisfied with these financial arrangements.

(iv) Be satisfied with the amount of induction and continuing professional training that the other company is planning to provide for him.

(v) Be satisfied that the level of directors’ and officers’ liability insurance that will be available to him as NED is sufficient, and that the terms of the cover are acceptable.
(vi) Consider the company that is offering him the position of NED, and whether he actually wants to join it. He may have personal views about business ethics and company reputation, but he should be satisfied with the ethical and governance standards of the company and should have no concerns about its apparent reputation with investors, the general public, customers and other stakeholders. Relevant information about the company can be obtained from the company’s own annual reports for the past two or three years, as well as other published information on the internet and elsewhere. If he is not satisfied with ethical standards, governance standards or the company’s reputation but nevertheless accepts the position of NED, he could find himself in a difficult situation at some time in the future.

(vii) Be satisfied about the financial position and prospects of the other company. He should have studied its annual report and accounts for the past two or three years, and any other financial information that is available about the company. He should consider the potential problems that may arise for the company’s NEDs if it were to get into serious financial difficulty. He should be particularly concerned about any words of caution in the going concern statement and the auditor’s report.

Other ideas and suggestions may also have been acceptable in an answer to this part of the question.

Examiner’s comments

There were many good answers to this question, but there were also some weaker answers. In part (a), a common problem was to write about the procedure for appointing a new individual NED to the board, whereas succession planning is rather broader in scope. Planning is also forward looking, and anticipates what might need to be done in the future. Too many candidates wrote about reacting to a vacancy when it occurs in the board, and did not indicate a proper understanding of what succession planning is. Answers to part (a) were also, in many cases, short of ideas: they contained one or two relevant points but did not discuss the issue fully.

Answers to part (b) also tended to vary according to the range of ideas that candidates presented. Far too many candidate presented ideas as very short bullet points, without explaining sufficiently what the points were.
Mortier and Plasterer plc (M&P) is a UK listed commercial property development company. It has a well-established business in the UK, Europe and North America, but in recent years it has also been expanding its business aggressively in developing countries, where commercial property prices have been rising at a fast rate. There have been some predictions of a collapse in the commercial property price ‘bubble’ in the near future. If this were to happen, M&P would be exposed to the risk of substantial losses.

The newly-appointed chairman has been surprised to discover that business risk is not discussed at board meetings, and there does not seem to be a clear risk strategy. The chairman of the audit committee has told him that business risk has a low priority at meetings of the committee, where discussions on matters relating to the annual audit, the external auditors and internal audit take up most of the time. The Chief Executive Officer (CEO) has said that, in his view, internal control and business risk should be the concern of the internal audit department, and he was not aware of any problems.

The chairman has asked for your assistance, and has asked you to prepare ideas and suggestions for putting to the next full meeting of the board of directors. He would like to ensure that the board complies with best corporate governance practice with regard to its business risk management system, and he believes that the solution should be to establish a new risk sub-committee of the board.

Suggested answer

The banking crisis increased the awareness of inadequacy in business risk management within many of the banks that got into serious financial difficulty. The Walker Report in the UK contains lengthy comments and recommendations about risk management systems, and the 2010 amendments to the UK Corporate Governance Code introduce more explicit mention of the responsibilities of the board for business risk strategy. This question tested the candidates’ understanding of business risk and the relevance of business risk management to corporate governance.

(a) Explain the difference between ‘business risk’ and ‘internal control risk’, giving examples of each.

(5 marks)

Suggested answer

This part of the question required an explanation of the difference between business risk and internal control risk, with examples of each. Answers may have varied, but this part of the question was looking for some awareness that business risk or strategic risk is a risk that should be consciously taken on by the board of directors of a company. Internal control risk is concerned with establishing checks and controls to reduce the risk that something may go wrong: these risks are subject to management control, provided that management successfully identify them and react to them.

(i) Business risk for a company is the risk from unexpected developments or events in the business or business environment.

- They are risks of events or changing circumstances that are outside the control of the company’s management.
- Examples of business risk include unanticipated weakness in sales demand, volatility in sales and profits, unexpected action by competitors, and major developments in the political and regulatory environment, social and ecological environment, economic environment or technological environment that could have a significant impact on the business.

(ii) Internal control risks are risks of losses due to weaknesses or failings in internal systems and procedures, including machine breakdowns, human error and fraud.
- Losses from internal control risks should be within the ability of management to prevent, restrict or detect and correct when a failure occurs, by means of internal controls.
- Internal controls may be categorised as financial, operational and compliance controls. Alternatively, candidates may have described controls such as segregation of duties, supervision controls and so on.

(b) Discuss the relevance of business risk to corporate governance, and explain who should be responsible for the management of business risk within a company such as M&P.

Suggested answer

Business risk is relevant to corporate governance for a similar reason that internal control risks are relevant. The board of directors is responsible for safeguarding the assets of the company and the investment of the shareholders. Business risk provides a threat to shareholder wealth.

The objectives of a company should therefore be to achieve financial returns that are consistent with the amount of risk that shareholders are prepared to accept. As a general rule, investors will expect higher returns (profits and dividends) as a reward for higher risk, but set limits to the risk they will accept.

The board of directors therefore has a responsibility to determine the ‘risk appetite’ of the company – how much business risk the company should accept. It should also set limits to ‘risk tolerance’ – this is the maximum amount of risk that the company should tolerate, ideally measured in quantitative terms.

Executive responsibility for business risk management is delegated to the management of the company. Management develop and implement strategies within the overall strategic framework decided by the board, and should keep risk within the tolerance levels determined by the board. Management also has a responsibility to report regularly to the board about business risk.

The UK Corporate Governance Code includes a provision that the board of directors should, at least annually, review the company’s system of risk controls and report to the shareholders that they have done so. This includes not just the system of internal controls, but also the company’s risk management systems, including business risk management systems. Ultimately, the board is therefore accountable and answerable to the shareholders for business risk.

(c) Describe the key elements of a business risk management structure, and recommend organisational measures and procedures that should be taken by the board of M&P to comply with best UK corporate governance practice and also recognise its responsibilities for business risk.

Suggested answer

The board should ensure that an effective system of business risk management is in place. Since the audit committee of the board has many other tasks to deal with, the chairman favours the establishment of a special risk committee of the board.

If this risk committee is to take on the responsibility for carrying out the review of the effectiveness of the business risk management systems and reporting to the shareholders, it should consist entirely of independent NEDs. The risk committee should report to the board. Alternatively, the risk committee may report to the audit committee on its annual review and if so it may be acceptable to include an executive director on the committee, such as the finance director.
Management should be responsible for implementing a business risk management system. This may involve establishing a risk management committee of senior executives, and possibly employing specialist risk officers.

The risk management system should have elements similar to those for an internal control system. There should be a suitable control environment, and management must be aware of the importance of risk management issues. There should also be processes for identifying and assessing business risks, developing suitable business risk strategies for each of the major risks identified, ensuring that information about risk is sufficiently communicated and monitoring actual performance and actual risk exposures, to ensure that these are within the board’s strategic guidelines.

There should be regular reports on risk and risk exposures by management to the board’s risk committee. Risk should be a standing item on the agenda for board meetings. Risk strategy should be kept under continual review and all directors should be encouraged to contribute their ideas on strategic risk. The chairman should ensure that all board members are given suitable training in risk awareness and risk management.

Other ideas and suggestions may also have been acceptable in an answer to this part of the question.

Examiner’s comments

The most surprising weakness in many answers to this question was that, having correctly distinguished between business risk and internal control risk in part (a) of the answer, candidates spent much of parts (b) and (c) writing about internal controls and internal control systems. Many candidates also did not include in their answers that management have the executive responsibility for managing risk, and conducting operations within the risk strategy guidelines set by the board. Too many candidates assumed in their answers that the board, or an audit committee or a risk committee of the board, have executive responsibilities for the management of business risk. The managers do the managing and the board and board committees set the strategy and then monitor, rather than manage.

Only a small number of candidates mentioned in their answers the board’s responsibility (UK listed companies) for reporting on risk and the risk management systems to the shareholders, both as a requirement of the UK Corporate Governance Code and also as part of the business review.
4. The Chief Executive Officer (CEO) of Notgood plc (‘Notgood’), a UK listed company, resigned a few months ago following the announcement of unexpected losses by the company for its previous financial year. The search has begun for a successor. A firm of head hunters has identified one individual as a suitable CEO, and the remuneration committee was authorised by the board to enter into discussions with him about a suitable remuneration package.

As company secretary of Notgood, you are visited by the chairman of the remuneration committee, who has just returned from a meeting with the individual and his solicitor. The meeting did not go well. The individual asked for a basic salary that was 20% higher than the salary paid to the previous CEO, and argued that he was only asking for the same level of fixed pay that similar companies in the sector were paying to their CEOs. He also asked for pension contributions equal to 7% of his basic salary and annual cash bonuses, which the remuneration committee chairman thought was too high.

The chairman of the remuneration committee said that she had explained the company’s remuneration policy for senior executives to the individual. The company tries to achieve a balance between fixed and variable elements in the remuneration package. About 50% of annual cash bonuses are available for meeting financial targets, and the other 50% are awarded for achieving environmental targets for reductions in waste and pollution. The company also has a share option scheme, with the award of share options based on the achievement of targets for Total Shareholder Return (TSR).

The individual had rejected the suggestion that any of his cash bonus should be based on achieving environmental targets, given the urgent need to restore the company to profitability. He also wanted to receive grants of shares as part of a long-term incentive scheme, not share options.

The remuneration committee chairman would like your advice about the response that she should give to the individual’s demands for remuneration. She emphasises that the company must comply with best governance practice on senior executive remuneration, although she is no longer sure what principles are included in the Combined Code on Corporate Governance.

(a) Discuss the principles on the remuneration of executive directors, as recommended in the Combined Code on Corporate Governance (now the UK Corporate Governance Code).

(8 marks)

Suggested answer

The UK Corporate Governance Code (formerly the Combined Code) contains several principles on remuneration of senior executives:

(i) Remuneration for executive directors (and other senior executives) should be sufficient to attract and retain individuals of the required quality, without paying them more than is necessary.

(ii) A significant proportion of the total remuneration package should be linked to corporate and individual performance.

(iii) The remuneration committee should use interfirm comparisons with care, avoiding the risk of ‘ratcheting up’ pay levels and deciding where to position the company in relation to other companies.

(iv) The remuneration committee should be sensitive to the pay and working conditions of other employees in the company.
(v) There should be a formal and transparent procedure for developing policy on executive remuneration and deciding individual remuneration packages.

(vi) No director should be involved in deciding his/her own remuneration.

(vii) The remuneration committee should consult the chairman and/or CEO about their proposals for executive remuneration.

(viii) The remuneration committee should be responsible for any decision to appoint remuneration consultants. This is not a matter for the board as a whole to decide.

(ix) The chairman should maintain contact with the main shareholders about the remuneration of executive directors and other senior executives.

Other points may have been acceptable.

(b) **Make recommendations to the remuneration committee chairman about the measures the committee should take next, and how the board should respond to the demands of the prospective CEO in order to comply with best governance principles and practice.**

*(12 marks)*

**Suggested answer**

The remuneration committee chairman should keep the company chairman informed about developments, and may even ask him for advice. The company chairman should be responsible for notifying the main shareholders about any issues relating to the remuneration package of the CEO.

The committee should be aware of the board’s policy on senior executive remuneration, and should adhere to it. This policy should be set out each year in the directors’ remuneration report, and shareholders should expect the board to apply the policy.

If the board fails to apply the remuneration policy it has established and offers the CEO a larger remuneration package than the policy would suggest is reasonable, there may be an adverse reaction from the shareholders. In particular, the remuneration committee chairman needs to understand that shareholders may vote against the directors’ remuneration report at the AGM, and/or may vote against the re-election of a remuneration committee member if the opportunity arises at the AGM.

The remuneration committee should apply the specific guidelines in the UK Corporate Governance Code (and its Appendix on remuneration) and should not be prepared to compromise on these. The Appendix states that normally only basic salary (the fixed element) should be pensionable. The demand of the prospective CEO for pension contributions to be based on annual bonuses as well as basic pay is, therefore, not acceptable.

The prospective CEO has asked for grants of shares instead of share options. This would require an entirely new long-term incentive scheme for just one individual, which is unreasonable. It would also need to be approved by the shareholders in general meeting, and this may be difficult to obtain. The remuneration committee should reject this demand.

It may be appropriate to hire remuneration consultants (unless this has been done already) to investigate the claims of the prospective CEO about basic pay for CEOs in comparable companies. The consultants could also recommend a remuneration package for the CEO as a counter-offer to his demands.

On certain other matters there may be room for negotiation, such as the level of basic salary and pension contributions. There may also be scope for negotiation on annual incentives, but the
remuneration committee should consider the board’s policy on payments for social/environmental performance and should be reluctant to agree to annual bonuses based entirely on financial performance – since this policy does not apply to other senior executives.

The remuneration committee should not overlook arrangements for severance payments in the event that the CEO is dismissed for ‘failure to perform’. The contract should include provisions for severance payments that reflect the guidelines of the ABI and NAPF.

Examiner’s comments

Part (a) of the question required a factual answer, and candidates either provided the guidelines of the Combined Code (UK Code) or did not. Many candidates scored reasonably well on this part.

Part (b) required some discussion of the facts given in the scenario of the question. Answers were expected to vary, according to the differing judgements or opinions of candidates. However, answers were not satisfactory if they suggested, briefly and with no supporting arguments, that the potential CEO must be told to take what is offered or the company would look for another individual to fill the role. Also, some answers did not refer to any of the details of the scenario at all.

5. Ultra Red plc (UR) is a UK listed company with global operations, specialising in the manufacture of a range of digital equipment and products. A few years ago, in response to negative publicity about the damage it was doing to the global environment and the relatively poor working conditions of its employees in developing countries, the company began to publish an annual Social and Environmental (SE) Report. This is now produced as a separate document at the same time as the annual report and accounts. It is distributed to all shareholders asking for a printed copy of the report and accounts, and is available to any member of the public who asks for a copy. The SE Report is also accessible on the company’s web site.

The SE Report consists mainly of narrative explanations, with a few performance figures, graphs and charts, and it is written in easy-to-understand language. However, it is not highly regarded by the company’s shareholders and it seems to have done little to improve the company’s poor social and environmental reputation. The SE Report has been criticised by some investors as a public relations document, lacking real substance. Some investors have also complained about the limited amount of information in the annual business review about environmental and social matters.

The board of directors is surprised by the poor response of investors to its SE Reports. The board members recognise the responsibilities of the company as a ‘corporate citizen’ and are concerned that the company’s initiatives in this area have not been properly recognised. Some members of the board have therefore suggested that the company should adopt the reporting standards of the Global Reporting Initiative (GRI) Framework. Others argue against this, and suggest that it would be sufficient to provide more information in the annual business review on social and environmental matters.

(a) Explain the limitations of the type of SE Report that the company has been publishing, and suggest why it may have failed to improve the company’s social and environmental reputation.

(10 marks)

Suggested answer

A company cannot restore its reputation for poor business ethics or poor ‘corporate citizenship’ simply by publishing SE reports. It should be able to demonstrate its commitment to these objectives through actual policies. It can take a long time to re-build or establish reputation.
The company’s SE Reports may not have been brought sufficiently to the attention of the company’s main shareholders, particularly those who have Socially Responsible Investment strategies and policies. If this is the case, the chairman should try to discuss the company’s CSR policies and SE reporting with these shareholders.

There are several reasons why the type of report produced by the company does not have much of an impact:

- It is produced as a separate document in print and may be in a different part of the company’s web site from its investor relations information. If so, intended readers of the report may not be aware of its existence.
- There are no regulations about what SE Reports should contain. The company can decide what to include and what to exclude. Good results may be published and poor results excluded. Poor aspects of social or environmental performance may be ignored entirely by the reports. As a consequence, the reports are often regarded as publicity/public relations material. This is particularly the case when the reports are largely in narrative form.
- The SE Reports appear to lack quantitative information. Potential users of these reports may be much more interested in quantified performance measures and comparisons of actual performance with a target or objective.
- Even where quantified data is provided in these reports, they are not necessarily reported using measurements that users understand and can compare with measures published by other companies. In the UK, the government provides ratios for converting environmental measures into standard measures (for example, converting skips full of waste into tonnes of landfill, and consumption of heat into tonnes of carbon dioxide emissions), but companies are not required to use these conversion factors. If they do not, quantified measurements have limited meaning and significance.
- Quantified data produced in SE Reports is not usually subject to independent audit and verification by environmental audit specialists. If information is not audited, users may doubt its accuracy and reliability.

**b)** Discuss the comparative merits of producing sustainability reports using the GRI Framework, or something similar, and providing information on social and environmental matters in the company’s business review within its annual report.  

(10 marks)

**Suggested answer**

The GRI Framework is a framework used by companies around the world for producing sustainability reports. It is a voluntary framework that encourages ‘triple bottom line reporting’ on economic performance, social performance and environmental performance. It therefore provides a more balanced view of a company’s achievements. It brings financial performance and SE performance into a single reporting structure, instead of keeping them as separate reports.

Using an established framework for sustainability reporting (or SE reporting) provides standardisation in reporting, and this makes comparisons between companies easier. (However, comparisons may still be difficult, because appropriate/suitable performance measures differ according to the nature of the industry in which the company operates.)

Sustainability reports provide extensive quantified data about performance on social/employment and environmental matters, as well as financial matters. Standard conversion factors can be used to convert various measures of environmental performance (for example, consumption of heat and water, and emissions of toxic waste) into standard measures of performance.

In the UK, quoted companies are required to include information in their annual business review (a part of the annual report) about environmental matters, the company’s employees and social
and community issues. This should include information about any policies the company has on these issues and the effectiveness of those policies.

In addition, the business review should contain, where appropriate for an understanding of the position of the business, key performance indicators relating to environmental or employee matters.

These company law requirements have the advantage of requiring quoted companies to report on these matters and to include the information in the annual report and accounts instead of (or as well as) in a separate SE report. However, the legal requirements are not specific about how much information should be included in the review or what it should consist of.

Companies that want to pursue a strategy of ‘corporate citizenship’ may prefer to report on their performance voluntarily rather than restrict their reporting to compliance with legal requirements. Using the GRI Framework would send a much stronger message to investors about the company’s ‘CSR credentials’.

Candidates may have reached different conclusions and made different comments, and were credited according to the merits and clarity of the points that they made.

**Examiner’s comments**

This was not a popular question, but it dealt with the basic issues of social and environmental (or ESG) reporting. A large proportion of candidates who attempted this question did not answer either part of the question directly and instead wrote generally about SE reporting.

BP provides an interesting example of governance in this area. Its social and environmental reports were highly regarded, yet the company was subsequently criticised for poor risk management that contributed significantly to the Gulf of Mexico oil spill in 2010. Reporting on social and environmental matters, and convincing stakeholders about the authenticity of those reports, are two separate (but related) issues.

6. **Bandit plc** is a large and profitable UK listed company with global operations. However, although it has been consistently successful for many years, with annual profits growing at an average of about 10% per year, it has been losing market share to some of its competitors. The newly-appointed chairman of the company, having analysed this problem for some time, has come to the opinion that the company has an ineffective board. He thinks that, although the board members between them have an excellent range of experience and skills, well-suited to the needs of the business, the board is not functioning as well as it should do. As chairman, he recognises his responsibility to make improvements.

He consults the company secretary, who offers the opinion that decision-making on operational matters by the board is driven by the Chief Executive Officer (CEO), and invariably the CEO’s recommendations to the board are accepted without much questioning. The company secretary suggests that, in order to create a more effective board, the chairman should review boardroom practice and boardroom behaviours.

**Required**

Suggest the weaknesses that may exist currently in boardroom practice and boardroom behaviours, and recommend improvements that the chairman should introduce to create a more effective board of directors.

(20 marks)
Suggested answer

The board does not seem to be acting as an effective decision-making body, providing leadership to the company. Instead, much of the authority for decision-making seems to have been assumed by the CEO. This indicates poor chairmanship of the board and failings in basic boardroom practice.

The new chairman needs to re-establish the authority of the board, and before announcing any changes to the other board members he should speak privately to the CEO, to let him/her know about the planned changes and the reasons for them. It is important that the chairman and CEO should work constructively together, and the acceptance of the boardroom changes by the CEO will be necessary in order to avoid arguments and disputes.

The board should have a list of matters reserved for its own decision making. If such a list does not exist, a new list should be prepared by the chairman in draft form, assisted by the company secretary, for discussion and approval by the full board.

The chairman should ensure that board meetings are held as frequently as necessary to enable the board to carry out its responsibilities fully.

The chairman also has the responsibility for ensuring that all directors contribute to board discussions. This is partly a matter of managing the conduct of meetings, but it is also partly dependent on all directors have sufficient reliable information on which to base their opinions and suggestions.

The chairman should, therefore, try to ensure that all directors receive sufficient reliable and relevant information about matters for discussion at board meetings. This information should be received by the directors in good time for them to study it in advance of the next board meeting.

The chairman should ensure that the agenda for each board meeting is appropriate, so that the board will discuss all relevant issues. Meetings should be clearly minuted to indicate decisions reached by the board and action points for which individual board members are responsible. The company secretary may be given the responsibility for checking in advance of board meetings that action points have been acted upon by the director responsible.

The ineffectiveness of the board may be attributable not only to boardroom practice, but to the attitudes and behaviour of board members. The NEDs may be unclear about what their role should be and may be reluctant to question assumptions and established viewpoints, and provide constructive challenges to proposals from executive management. The board may also have been reluctant to reach ‘closure’ on items of business, making it indecisive so that the only decisions taken might be those pushed through by the CEO.

It is also possible that executive directors regard the activities of the board as a restraint on their ability to act, and consider ‘best practice’ – NEDs in particular – as a ‘business killer’.

Suggestions for behavioural change

The chairman needs to introduce improvements, and changes in attitude and behaviour are needed as well as changes in boardroom practice. Some suggestions are as follows:

(i) All members of the board should be given extensive training in corporate governance, and the contribution of an effective board to best practice.

(ii) A change in culture at the top is needed. Directors need to be aware of their responsibilities. They should develop a wider perspective of the business, directors should look ‘forward and out’ as well as ‘backwards and in’.
(iii) The process of making NEDS can be made more effective by giving them greater exposure to the company’s operations.

(iv) The remuneration committee should be asked to review the company’s incentive schemes for remuneration of senior executives, and recommend changes if sufficient emphasis is not being given to the long-term interests of the company.

(v) The chairman should carry out rigorous annual performance evaluations of the board, its committees and individual board members. Directors who are not contributing to good governance through contributions to the board’s work should be asked to resign.

Examiner’s comments

A wide range of different points could have been made in answer to this question. Answers were treated on their merits and a range of different answers were acceptable.

This was a popular question and there were some good answers. However, a number of answers were weaker because candidates appeared to run out of time at the end of the examination, and only had time to scribble a few hasty ideas, often in sketchy bullet points. Some candidates also focused too much on the need to change the composition of the board, whereas the information in the question about the range and relevance of the skills of the board members should have discouraged too much emphasis on this issue. The question scenario referred to a newly-appointed chairman of the board. A few answers stressed the role of the senior independent director in sorting out the problem, when the chairman, as leader of the board, has a much greater responsibility.

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.