Important notice

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

Examiner’s general comments

Before looking at suggested answers to the questions in the June 2011 exam, it may be useful to consider why some candidates did not achieve a pass and how most candidates might have performed better than they did.

There seem to be three main reasons for poor performance in the exam, and none of them are unique to Corporate Governance:

(i) To achieve a satisfactory standard in the Corporate Governance exam, it is essential to study the syllabus topics in some detail. It is difficult to write an answer to a 25 mark question without having some basic knowledge and understanding. Disappointingly, many candidates appeared under-prepared and had not done enough studying and learning of the subject.

(ii) The requirements of each question should be set out clearly. There is no intention to mislead candidates in any way. Unfortunately, there is a tendency for candidates to write what they know about a topic instead of answering the actual question. If comments in an answer do not seem relevant, they will not earn marks.

(iii) A number of candidates did not allocate time between the questions as efficiently as they should have done. A few candidates answered only three questions. More candidates made a hasty attempt at a fourth question, but were clearly running out of time. It is very difficult to pass an exam when 25% of the questions have not been answered or have been answered much too hastily.

Candidates who avoided these pitfalls in general performed reasonably well, although there were other common weaknesses that kept marks lower than they might otherwise have been:

- Corporate Governance is based on a combination of laws, regulations and principles. In some countries, the rules-based approach is more pronounced, but in countries such as the UK there is more emphasis on a principles-based approach. Many candidates seem to find it difficult to
come to terms with principles and voluntary arrangements, and prefer the idea of rules, regulations and what is 'right' in any given situation. As a consequence, many answers to the scenario-based questions were rigid and uncompromising in their approach. The better answers considered different options and took a more flexible or a more selective approach and, as a result, came across to the marker as more sensible and commercially aware.

- A different problem is the tendency of some candidates to present points in a list of very brief bullet points. The presentation of answers in a list of bullet points is perfectly acceptable but the points must be complete. A short note of three of four words is insufficient because it requires the marker to assume or guess at the point that was intended. Candidates are at risk of not earning marks for what are probably valid points but which have not been clearly explained.

1. Ambio is a premium listed UK company. It recently made a takeover bid for a large foreign company, as part of a strategy of the board of directors to grow the business globally. The decision to make the bid was taken after a series of board meetings on company strategy, and the board recognised that there was a significant business risk in extending the company's foreign operations. To finance the purchase cost of the takeover, the company announced that it would have to make a large rights issue of new shares. Several major shareholders objected to the bid, on the grounds that the offer price was too high. Some shareholders had meetings with the company chairman to discuss their views, which the chairman passed on to the full board of directors. Eventually, the board gave way to shareholder pressure and agreed to reduce the offer price for the takeover. However, the board of directors of the takeover target rejected the lower offer, and the takeover negotiations came to an end with failure to agree terms.

Ambio will incur very large costs in connection with the failed bid, mainly from fees and expenses payable to investment banks, firms of lawyers, accountants and other advisers. The total amount of costs written off will be equal to the company's total equity dividend payments to shareholders in the previous financial year. Many shareholders have expressed their anger about these costs, and have blamed the company chief executive officer (CEO) for proposing the ill-advised takeover bid and the company chairman for failing to lead the board in a challenge to the CEO's proposal.

Required

(a) Discuss, with reasons, whether the board of directors of Ambio has failed to comply with expected standards of best practice in corporate governance, in deciding to make the takeover bid and then to revise the offer in response to shareholder pressure.

(8 marks)

Suggested answer

Note: In the comments that follow, standards of best practice in corporate governance are assumed to relate to the principles and provisions of the UK Corporate Governance Code (the UK Code).

The situation described in the question is likely to be a rare event, although it is not unprecedented. Such an unusual event can test the resilience of a company’s corporate governance practices.

The board appears to have complied in some ways with best practice in corporate governance. It has complied in the following ways:

- The Ambio board recognised that there would be significant business risk in the strategy to expand globally. The amount of risk in the strategy would be much higher if economic conditions were volatile, than if economic conditions were stable in the markets of the
Without further information, it is therefore not clear whether the board has satisfied itself that the risk management system within the enlarged company (after the takeover) would have been sufficiently sound and robust. Failure to consider business risk adequately would be a weakness in corporate governance practice.

- A principle of the UK Code is that the board has a responsibility to ensure that a satisfactory dialogue with shareholders takes place. Although contact with shareholders will usually be through the chairman, CEO or finance director, the chairman should ensure that all the directors should be made aware of the concerns of shareholders. Ambio’s chairman appears to have done this, meeting with shareholders and reporting their concerns to the rest of the board.

- A provision of the UK Code is that the chairman should discuss strategy with major shareholders. In the matter of the proposed takeover bid, Ambio’s chairman appears to have done so.

- Although the UK Code also suggests that non-executive directors (NEDs) should be offered the opportunity to attend scheduled meetings with shareholders, and should attend meetings if shareholders ask for them to do so, it would seem that the meetings by Ambio’s chairman with shareholders were not scheduled and that the attendance of NEDs (or the senior independent director) might not have been necessary. However, it could be argued that other directors might have attended meetings with shareholders, to make sure that the views of those shareholders were fully understood.

- The UK Code does not suggest that the board should give way to shareholder pressure on all matters but, in this case, the board listened to the views of shareholders and reduced the size of the takeover bid. It could therefore be argued that the board engages with its shareholders and responds positively to their concerns. However, it could also be argued that in an important respect the board did not engage in dialogue sufficiently with its shareholders. The takeover bid was made by the board, and in view of the adverse shareholder reaction, it might be supposed that the board failed to discuss its strategy and intentions with shareholders before the bid took place. There are difficulties with discussing price-sensitive matters with shareholders before a public announcement is made. Even so, the board might have been better aware of shareholder opinion beforehand and the board was not ‘in touch’ with its shareholders as much as it could have been.

**Examiner’s comments**

Some candidates suggested that shareholders should have been informed about the intended takeover bid before it was made but this would have made them insiders and would not be what the shareholders would want. Some candidates also assumed, incorrectly, that the rights issue had been forced though without shareholder approval. Others assumed, also incorrectly, that shareholders would not have been given an opportunity to vote on the takeover transaction if an offer had been accepted by the target company’s board.

(b) **Describe how institutional investors with shares in Ambio should follow best practice in stewardship in their dealings with the board of directors of the company.**

(8 marks)

**Suggested answer**

It is important to recognise that the shareholders should not get involved in the detailed management of their company. Shareholders appoint the board of directors to run the company in their interests. They can discuss their concerns with the board, and try to influence board decisions, but it is for the board to decide what is in the best interests of the company.
UK institutional investors with shares in Ambio might be expected to comply with the principles of the UK Stewardship Code. These principles include a requirement that institutional investors should monitor the companies in which they invest, in order to decide when it might be necessary to enter into active dialogue with the company’s directors. Monitoring will include meetings with directors, and records should be kept of what was discussed at these meetings. Investors should also keep an audit trail of votes against the company’s board, or abstentions from voting. They should also attend general meetings of the company where appropriate and practicable. They should try to identify any problems at an early stage and if they have concerns, they should raise them with an appropriate member of the board of directors.

Institutional investors should be careful about the risk of receiving information from a company that makes them insiders, and unable to deal in the shares of the company (without breaking the law). The nature of discussions with directors should therefore have regard to this risk, and is one reason why records should be kept of any private meeting with members of the board of an investee company.

During the takeover negotiations, shareholders should have tried to avoid receiving inside information, for example, because as insiders they would not be able to sell (or buy) shares in Ambio when they might otherwise wish to do so.

Institutional investors should also establish clear guidelines on when and how they will escalate their activities, and enter into active dialogue with the board of a company (initially on a confidential basis). Concerns may relate to strategy or performance issues, or social and environmental risks.

Institutional investors should, where appropriate, be willing to act collectively and engage together with a company’s board.

In response to the takeover bid by the board, institutional shareholders in the company would need to consider carefully how they should present their views or act collectively, for example, by demanding changes in Ambio’s board.

The shareholders should also have a clear policy on voting at general meetings and should make disclosure of their voting activity. They should seek to vote all the shares they hold.

Examiner’s comments

Many candidates provided a satisfactory answer based on the principles of the UK Stewardship Code. Some candidates chose to address the specific situation of Ambio, the company in the question. This was accepted as a valid approach, although, as a result, there was some overlap between their answers to parts (b) and (c).

(c) Suggest what measures might now be taken by shareholders who remain angry and dissatisfied with the chairman and the CEO of Ambio, and believe that they have provided inadequate leadership for the company.

Suggested answer

Shareholders who remain dissatisfied with the actions of the board of Ambio, and the high costs that have been written off, should continue to make their views known to members of the board through active dialogue. Initially, this may take the form of confidential meetings, although some investors may choose to encourage the reporting of their dissatisfaction in the financial press and other media.

In their discussions with the company chairman, shareholders may raise the subject of the board’s effectiveness, possibly in the context of the published guidance from the FRC on board effectiveness. They may remind the chairman that they expect him to report personally in the
company’s annual statements about board leadership and effectiveness. The FRC guidance includes the suggestion that there must be good communication between the board and the shareholders and that all directors should be made aware of the views of major investors in the company.

Various institutional investors may discuss the matter between themselves, with a view to collaborating on an initiative. Such an initiative might involve meetings with the chairman or the CEO, and recommendations that they should resign. Alternatively, there may be dissatisfaction with the independent NEDs of the company and their failure to take a stand against the takeover bid. A meeting with the senior independent director may be arranged, to voice opinions about the need to remove the chairman or CEO, or to change the NEDs and ‘shake up’ the board.

The UK Code includes a provision that the directors of FTSE 350 companies should stand for re-election annually. In other listed companies, one third of directors will stand for re-election each year. If some of Ambio’s shareholders wish to do so, they can try to gather support for a vote against the re-election of one or more directors at the next AGM. However, any public move against members of the board will be made with caution because shareholders will not wish to engage in action that might reduce the market value of their shares.

In addition to discussing possible changes to the board, shareholders will probably also make their views known about the company’s dividend policy and the effect of the failed bid on the current year’s dividends.

Shareholders who remain dissatisfied have the option to reduce their shareholding in the company (‘go under weight’ with shares of Ambio in their investment portfolio) or possibly sell their entire shareholding.

Examiner’s comments

The weakest answers to part (c) focused exclusively on ways of dismissing/not re-electing the chairman and CEO, or suggesting that shareholders should sell their shares. These are valid points but should be considered as options within a broader range of possibilities.

2. Setton Services (‘Setton’) is a small private UK company, which was established five years ago by Les Setton (‘Les’), an individual with great personal energy and entrepreneurial skills. He and members of his family own 100% of the shares in the company, which became profitable three years ago and continues to grow successfully. Les manages the company and is also the chairman of the board of directors, which consists of himself and three executive directors. He has a strong personality and dominates decision-making by the board.

Les thinks that he will continue to run the business for about three more years, and then hopes to sell it or to take the company on to one of the smaller stock markets in the UK. He can foresee that his young management team might want to buy the company from him, or that he might receive a takeover bid from a larger company.

Donald Mack (‘Donald’) is a good friend of Les, and has experience as a company secretary. He suggested to Les that if he plans to sell the company or to turn it into a public company in the next few years, he should consider making improvements in corporate governance. Les replied that he was not sure what corporate governance was, but that he thought the company was well-managed and successful, and so did not need any changes. He certainly believed that the board and the company’s management had to remain entrepreneurial and that corporate governance measures would inevitably mean more administration and bureaucracy. Donald said that he understood Les’s concerns, but that improvements in corporate governance could benefit the company and assist Les with his future plans.
Les also commented that he was considering a new incentive scheme, in which he would award new shares in the company to his executive directors and senior managers on condition that certain financial performance targets were met in two years’ time. He considered that such a scheme would help to motivate his senior managers and align their interests with his own objective of selling the company in the not-too-distant future.

Required

(a) Explain the difference between governance of a company and management. State your views, with reasons, about whether governance imposes bureaucracy on a company and stifles entrepreneurship.

(8 marks)

Suggested answer

The Cadbury Report (1992) defined corporate governance as the system by which companies are directed and controlled. Professor Tricker commented that, whereas management is about running businesses, governance is about seeing that it is run properly. Corporate governance is therefore concerned with how a company is led and controlled, in the interests of shareholders and other stakeholders.

Management of a company refers to the executive tasks of planning, co-ordinating and controlling its business activities. Management applies to operational activities and also to the implementation of strategies that have been decided or approved by the board of directors. Managers are given delegated authority to carry out their responsibilities and are generally led by, and are accountable to, the chief executive officer or a managing director. Management operates within a framework of governance provided by the board of directors.

Corporate governance refers to the leadership provided by the board of directors on behalf of the owners of the company (the shareholders), and also other major stakeholders. In terms of agency theory, the board of directors act as agents of the shareholders and are accountable to the shareholders for the way in which they use the responsibilities and powers given to them.

Governance matters include setting the overall business strategies for the company, with due regard to risk as well as return, and accountability to shareholders. A well-governed company is one that seeks to achieve the objectives of shareholders and other stakeholders, and to provide full and transparent disclosure about how this is being done.

Compliance with corporate governance principles and provisions has been criticised as a box-ticking exercise that creates no value and is bureaucratic in nature. In practice, this might be how corporate governance measures are applied in some companies. However, the aim of best practice in corporate governance is for the board of directors to provide entrepreneurial leadership for a company. Sensibly applied, corporate governance measures should enhance rather than restrict company leadership.

A company secretary, through his or her knowledge of corporate governance issues, company administration and how the board and its committees operate, should be able to contribute to effective corporate governance, so that the board remains entrepreneurial in its outlook and corporate governance compliance does not become a bureaucratic exercise.

Examiner’s comments

Most candidates provided a reasonable answer to this part of the question. Very good answers mentioned the fact that problems with governance arise when there is an agency-principal relationship, but the difference between governance and management can be explained in many ways. Only a few answers did not explain correctly what corporate governance was. A weakness in some answers was not answering the second part of the question. On the other hand, good
answers commented that corporate governance structures may be criticised for slowing down the decision-making process, by requiring certain decisions to be made by the board.

(b) **Excluding changes in remuneration policy, suggest changes that might be made to corporate governance practice in Setton, and explain how these would benefit the company or help Les with his future plans.**

(10 marks)

**Suggested answer**

Note: A challenge for candidates answering this question was to identify aspects of corporate governance that could benefit a private company whose owner has plans to sell the company or turn it into a public company and launch it on to a stock market in the fairly near future. Candidates should not have discussed a range of corporate governance issues that might not be appropriate for a private company.

Changes in governance and management at Setton might not be needed as long as Les and his family intend to own the company. However, if he plans in the foreseeable future to sell some or all of his shares in the company, he should be advised to improve some aspects of corporate governance. The purpose of such improvements should be to provide evidence for a potential buyer that the company is well-governed, and give the potential buyer some reassurance about the value of the company as an investment.

The following changes might be beneficial:

- The board could introduce one or more NEDS to the board. As Setton is a private company, these individuals need not be independent and might be individuals that Les already knows and trusts. Any NEDs should bring useful skills and experience to the board. In the case of Setton, there may be value in appointing an individual with experience of taking companies on to a minor stock market in the UK, or with experience in the practicalities of selling companies.

- Les might consider the appointment of a finance director to the board. This individual might also have had some experience with listing or bringing a company to a stock market. Private companies often lack sufficient financial expertise to satisfy the requirements of stock market investors. The appointment of such an individual would, therefore, help to prepare the company for a conversion to public company status and its application for acceptance to a stock market.

- Also with a view to selling the company eventually, Les should consider developing the reporting systems within the company, particularly reporting by management to shareholders.

- A change in the external auditors to a larger and more experienced audit firm may be appropriate, to provide greater confidence in the reliability of audited financial statements.

- Les appears to be a dominant individual on the board of directors. He should consider the benefits of encouraging more balance on the board, partly by introducing NEDs but also by encouraging other executive directors to contribute more effectively. A potential buyer may see value in the fact that the company appears to have a well-balanced and experienced board in the company.

- If the executive directors are hoping to continue with the company after its sale or stock market launch, it might be appropriate to arrange training for them, particularly in matters relating to corporate governance.
• Les may not wish to spend much of his time on corporate governance matters. If it is decided that improvements in corporate governance might make it easier to sell the company (for a good price) at some time in the future, he might appoint an individual with company secretarial and administrative responsibilities, including the task of providing advice on corporate governance and helping to introduce any changes in practice.

**Examiner’s comments**

Most answers gave little or no consideration to the fact that the company in the question is a private company and, if it were to become a private company and obtain a stock market quotation for its shares, it would probably not seek a full listing. Consequently, the suggestions for improving corporate governance in Setton were based on the principles and provisions of the UK Corporate Governance Code and, therefore, were extreme and insufficiently justified. Appointing several NEDs, a company secretary and a new CEO or chairman might seem ‘good’ suggestions but no answers included how much these changes would cost the (private) company and hit its profits. A few candidates proposed the appointment of Donald as company secretary: whereas the creation of a company secretary position might be a useful suggestion, there is no clear reason why Donald might want the job.

(c) **Discuss the possible implications of the proposed policy of rewarding senior executives with grants of shares in the company.**

(7 marks)

**Suggested answer**

Granting shares to senior executives would be of some potential benefit if they succeeded in providing an incentive to the individuals concerned and also helped to align the interests of those managers with the interests of the company’s shareholders, who are currently Les and his family.

The individual managers would only be incentivised if they could see sufficient value in the grant of shares. This may be the case if Les has announced his intention to sell the company or to take it on to a stock market, because this would give the managers shares that they could sell or that should be marketable and have value. If Les changes his mind and does not sell the company, the only value in the shares would be the dividends they might earn. The grant of shares is, therefore, likely to motivate the managers affected to create a more valuable company that can be sold.

Les should also consider the implications of his proposed policy for existing shareholders and shareholder relations.

Other shareholders (family members) may not like the idea of giving away shares because this would dilute their share of the value of the company. Shareholder approval would also be needed for a scheme involving the creation and issue of new shares. If new shareholders are eventually created, Les would also need to consider the implications of having non-family members as shareholders. The new shareholders might expect greater openness and transparency from the company.

The intention appears to be that new shares will be issued in two years’ time, before the potential sale of the company after three years. It might be questioned whether an incentive scheme will have sufficient time to make any impact on the company’s value within two years. A three-year period before the shares are granted might be more appropriate (and in keeping with normal UK stock market practice).
Examiner's comments

Many candidates provided reasonable answers to this part of the question, although far too many answers commented on the company’s share price, without regard for the fact that Setton is a private company.

3. Sara King (‘Sara’) has just been appointed as independent non-executive director (NED) of a medium-sized listed company. She has been asked to act as a member of the three-member audit committee, which has oversight and responsibility for review of the company’s risk management system. At an introductory meeting with the chairman of the audit committee, Sara is told about some of the business risk issues facing the company at the moment:

(i) The company operates in a highly competitive industry, in which there are rapid technological developments. The global and national economies have been through a period of recession, but a period of sustained economic growth may now be underway. The company’s CEO has proposed a major investment in a new online service to meet customer demand in the expected economic upturn. To finance the investment, the company would probably have to increase its borrowings substantially.

(ii) The company’s external auditors have written to the board of directors commenting on the fact that the company does not have a disaster recovery plan, but might be well advised to develop one.

The board does not have a separate sub-committee with responsibilities for the risk management system.

The chairman of the audit committee tells Sara that business risk, including the need for a disaster recovery plan, are on the agenda for the next board meeting. He adds that it will be important for members of the audit committee to contribute effectively to the meeting, in view of strong views expressed recently by some directors about the lack of value of NEDs to the functioning of the board.

Required

(a) Explain the nature of business risk and the responsibilities of the company’s audit committee for business risk management.

(7 marks)

Suggested answer

Business risk is a term for the risks to a company’s business, such that actual performance could be much worse (or better) than expected, due to unexpected developments in the business and its environment in which it operates.

Events or developments in the business may include actions by competitors or changes in the nature of competition, and changes in the demand for goods or services. Changes in the business environment include changes in the general economy and in financial conditions, changes in technology that affect the industry in which the business operates, and political and regulatory changes. Business risk is two-way risk, in the sense that events could turn out either better or worse than expected. However, risk management is concerned mainly with preparing for unfavourable changes and taking measures to reduce their potential impact if they were to happen.

Some industries are more risky than others, in the sense that future developments are more unpredictable or conditions are much more variable, and the possibility of making significant
losses could be high. Similarly, some companies might expose themselves to more risk than competitors, for example, by borrowing much more (higher leverage risk) or taking bigger financial risks (for example, exposing itself to greater foreign exchange risks).

The UK Corporate Governance Code (the UK Code) states the responsibilities of the board of directors for risk and risk management, although the board may delegate some tasks to the audit committee.

The board is responsible for determining the nature and extent of significant risks it is willing to take in order to achieve its strategic objectives. This could be explained in terms of deciding the risk appetite and risk tolerance levels for the company. A board may be willing to take greater business risks in the expectation of making higher returns. The audit committee might then be given the task of monitoring the actual risk levels and checking these against the board’s policy on risk.

The UK Code also requires the board to maintain a sound risk management system and, at least annually, to conduct a review of the effectiveness of the risk management system (and tell shareholders that they have done so). The board should establish formal and transparent arrangements for considering how they should apply these principles.

In practice, this will often mean giving the audit committee responsibility for advising the board on matters relating to business risk management and the effectiveness of the business risk management system.

The FRC Guidance on Audit Committees states that executive management is responsible for the identification, assessment, management and monitoring of risk. However, the audit committee (if given the delegated responsibility by the board) should receive reports from management about the effectiveness of the risk management systems that they have established and also about the conclusions of any testing on the risk management system that have been carried out by internal or external auditors.

Examiner’s comments

Most candidates described the nature of business risk but a large number of answers provided comments about the responsibilities of the audit committee that were incorrect. The role and responsibilities of the audit committee are a core topic in the syllabus and it was surprising to find so many incorrect answers. The audit committee consists of NEDs and meets occasionally: far too many answers gave the committee an executive role. Some answers included the unusual suggestion that the audit committee should establish a sub-committee for risk management – indicating that they were uncertain what a risk committee might do if it is established, and the fact that medium-sized companies (with the possible exception of financial companies) are most unlikely to have a risk sub-committee of the board.

(b) What is a disaster recovery plan and how may such a plan contribute to best practice in corporate governance?

Suggested answer

A disaster recovery plan is a contingency plan for what should be done if an event occurs that seriously disrupts the business of an organisation. It may be called a business continuity plan, because the disaster may threaten the ability of the organisation to continue operating and would therefore cause substantial losses and perhaps result in insolvency. The disaster should be an event that is very unlikely to occur but where there is some possibility that it will. If may therefore be described as a ‘low probability, high impact’ risk. Examples of disasters may be the destruction of a major operating centre due to fire or bombing, or the total breakdown of a major IT system.
A disaster recovery plan involves making arrangements for the business to continue operating in the event of the disaster happening. It may involve, for example, making arrangements to use space in the premises of another company and having use of that company’s IT equipment. Alternatively, it may involve switching key operations from IT-based to a manual system or a simpler IT system.

A disaster recovery plan contributes to good practice in corporate governance because it is an element in the business risk management system that should reduce the potential losses from a risk event, should the event occur. It improves the effectiveness of the business risk management system, and the board is able to report on the existence of such a plan to reassure shareholders and other investors that risk is suitably managed by the company.

Examiner's comments

Most candidates provided a reasonable or good answer to this part of the question. However, a few candidates did not appear to know what a disaster recovery plan is.

(c) As company secretary, prepare a briefing note to Sara on how to be an effective NED, and commenting on what some of the common criticisms of NEDs are.  

Suggested answer

To: Sara King  
From: Company secretary  

Briefing note: Being an effective NED

Guidance on the role of NEDs has been provided in the UK Code and the more recent FRC Guidance on Board Effectiveness. Compliance with these guidelines should help you to perform your role as NED effectively.

UK Corporate Governance Code

The UK Code identifies four roles for a NED:

(i) As members of the board, NEDs should constructively challenge and help develop proposals on strategy.
(ii) NEDs should scrutinise the performance of management in meeting agreed objectives, and should monitor the reporting of business performance.
(iii) NEDs should satisfy themselves about the integrity of the financial information provided by the company and that the systems of internal control and risk management are robust.
(iv) Through membership of board committees, NEDs are responsible for deciding the levels of remuneration of senior executives and have a prime role in appointing (and removing) directors and in succession planning.

As an NED, you can assess your effectiveness by comparing your contributions to the workings of the board with these key roles.

The UK Code also states that directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively. The amount of time you are expected to allocate to this company should have been agreed before your appointment and specified in your letter of appointment. You should make sure that you meet this commitment.

You should also ensure that you receive sufficient induction to understand the company and its business sufficiently, so that you are able to contribute effectively to board discussions and decision-making. If you have not yet received sufficient induction, you should inform the chairman and insist that you receive it.
Improving board effectiveness

The FRC’s Guidance on Board Effectiveness suggests that, in order to become effective as a NED, you should build up recognition among the executive directors of your contribution, and you should seek to develop mutual respect so that you are able to work constructively together. Mutual respect will enable you to combine the roles of supporting the executives in their management of the business whilst at the same time acting as a monitor of their performance.

Decision-making is an important board function. The guidance states that in order to make effective decisions, it is essential to have timely, relevant, clear, comprehensive and reliable information. If you are not receiving enough information, or if you are not receiving it in good time to study it before board meetings, or if the information is not reliable, you must discuss this with the chairman and insist on measures to deal with the problem.

The guidance also suggests that NEDs should supplement their knowledge of the business with the views of shareholders and other stakeholders. This will help them to obtain different perspectives of the company’s progress and performance, which might help you to reach better judgements.

Common criticisms of NEDs

You should try to avoid the weaknesses and failings for which many NEDs in large public companies have been criticised:

- In the UK, boards of directors of UK companies have been accused of being a ‘self-perpetuating oligarchy’, which fail to stand up for shareholders’ rights against over-powerful executives.

- Some individuals may hold too many NED positions in public companies, more than they can possibly serve effectively. However, the UK Code now states that appointments to the board should be on merit, against objective criteria and with due regard to the benefits of diversity on the board, including gender. The board of a (listed) company should also not agree to one of its full-time executives taking on an NED position at more than one FTSE 350 company or a chairmanship in a FTSE 350 company. This may reduce the problem of the ‘old boys’ network’ to some extent.

- NEDs may not meet with shareholders frequently enough to understand sufficiently well the concerns and views of the company’s shareholders. However, the UK Code states that the board chairman should ensure that all directors are made aware of the issues and concerns of major shareholders, and that the board should keep in touch with shareholder opinion by whatever methods are the most practical and efficient.

- UK law makes no distinction between executive and non-executive directors. In principle, the NEDs could be equally liable with the executive directors for breach of statutory duty, such as the duty of care. The threat of criminal or civil liability could make NEDs more inclined to support their executive colleagues.

Conclusion

The effectiveness of NEDs in a company, therefore, depends on a variety of factors. The most important of these are the willingness of the board to enter into dialogue with its shareholders, the commitment of NEDs to their roles in the company and the willingness of major shareholders to engage with boards of the companies in which they invest.
**Examiner’s comments**

Many candidates provided a reasonable or good answer to this question. However, most answers were not presented in the form of a briefing note, as required by the question. Weaker answers tended to make only a small number of points so that they suffered from significant omissions.

4. Newman is a large multinational company. It has plans to invest in the construction and operation of a new manufacturing facility in a developing country. In time, the manufacturing operations are expected to employ thousands of workers, many of them from the local area. The country has a rapidly-growing population, education standards are currently fairly low and there are concerns about standards of public health. The country has a despotic political leader who has been in power for over fifteen years.

The board of directors of Newman has made considerable efforts in recent years to promote the image of the company as a ‘global corporate citizen’. One of its board members, an executive director, has been given special responsibilities for corporate social responsibility (CSR). In carrying out his work on CSR, this director regularly seeks the advice of the company secretary. They are planning a fact-finding visit to the country where the proposed investment is planned and, on their return, the director will report to the board on the CSR issues that the company will need to consider if the decision is taken to invest in the country.

**Required**

**(a)** Define ‘corporate citizenship’ and give reasons why companies think that it is important.

**(7 marks)**

**Suggested answer**

Corporate citizenship refers to a company acting as a citizen of the society in which it exists and operating in the same way that individuals might be expected to act as citizens in their society. In this respect, citizenship involves recognition of responsibilities or duties as a citizen and acting in ways that are beneficial to society as a whole, rather than acting exclusively in self-interest. A company might be considered a corporate citizen if it seeks to make a profit from its activities but, in doing so, has due regard to social fairness and justice, the environment, ethical behaviour and the general economic well-being of society.

In acting as a corporate citizen, a company has a conflict of interest between its profit-making objectives and the interests of society, and it is sometimes suggested that a company secretary can act as the ‘conscience’ of a company by drawing attention to matters where such conflicts of interest arise.

For global companies, corporate citizenship is more difficult to define because these companies operate in different countries with different ethical and cultural values.

Companies may consider corporate citizenship to be important for several reasons:

- Companies may enhance their reputation by acting as a corporate citizen. Although there is no proven connection between reputation and commercial success, it seems possible that a good reputation will improve a company’s relationships with customers, suppliers and governments and regulators.

- Companies may be aware of the need to develop sustainable businesses that will be able to prosper in the future in conditions of scarce resources and increasing regulation against
pollution. Acting as a corporate citizen ‘now’, with concern for the environment, can help a company to survive and succeed in the longer term.

- Concern for the community, particularly in developing countries, can have implications for a company’s future business. A company might need a healthy, well-educated and skilled workforce. If so, it should be concerned about raising standards of health and education. A company should also be concerned about raising general standards of living within the communities where they operate, because an increasingly wealthy population is a source of customer demand for the company’s products.

- Directors and senior management may have a genuine ethical concern about the way in which business is conducted and might want their company to act in a responsible and ethical way. In addition, companies should want to ensure that their employees do not act in a way that damages society and may be illegal (for example, bribery).

**Examiner's comments**

On the whole, answers to this part of the question were reasonably good, although some candidates focused on the moral and ethical obligation of companies to act in an enlightened way to society and the environment, to the exclusion of more commercial issues. However, the tendency to focus on ‘doing good’ to the exclusion of commercial considerations was a much more significant weakness in many answers to part (b).

(b) As company secretary accompanying the CSR director, prepare a board paper in advance of your fact-finding visit, in anticipation of the issues that the visit may raise. Discuss the risks and opportunities that the company may need to consider with regard to CSR if it invests in the developing country and, in particular, the:

(i) Social issues.
(ii) Environmental issues.

Where appropriate, give examples of current best practice and issues that other companies have faced.

*(18 marks)*

**Suggested answer**

To: Board of directors  
From: Company secretary  
Date: 9 June 2011

**Risks and opportunities with corporate social responsibility issues**

**Introduction**

I have been asked to prepare a board paper in anticipation of the proposed fact-finding visit by myself and the CSR director, setting out the issues that the visit may raise and the board might therefore be required to consider now or in the future.

**Risks and opportunities**

CSR issues may create both risks and opportunities for the company. The opportunities are in creating a successful and sustainable business in the long-term. The risks might create damage to the company’s reputation and, through this, damage to the business.

Investing in a developing country will create particular risks and opportunities of a CSR nature. These are discussed in the rest of this report.
This paper assumes that the board has as an objective that the company should act as a corporate citizen.

**Social issues**

If the company wishes to act as a corporate citizen, it should pursue social policies that are consistent with this aim. Investment in a developing country will give rise to several threats and opportunities of a social character:

- An important social issue will be employment and rates of pay for local employees. The company may have a choice between recruiting local labour (and training them) or hiring immigrant labour, if this is permitted by the country’s laws. In a developing country, it may be possible to pay low wages but the company will need to decide whether to pay above-normal levels of wages and, if so, how high the level of wages should be. There could be some risk of over-paying as well as under-paying employees. Paying low wages might have an adverse effect on public opinion ‘at home’, if the matter is reported in the media.

- When hiring local labour, the company should have regard to discrimination. There may be a culture of discrimination within the country, such as a preference for recruiting men rather than women. There may also be racial or tribal discrimination. The company will have to consider how it deals with such problems, as it tries to apply non-discriminatory employment policies. Depending on the local laws on child labour, the company may also need to impose a rule against the use of child labour or the use of child labour by any major supplier. There might be some political risk for the company in deciding on its policy for hiring immigrant labour, due to anti-immigration policies of the local government.

- We are told that standards of education in the country are fairly low. The company may, therefore, consider a policy of educating its employees or providing funding for wider education within the schools system (for example, by contributing to the building and operation of new schools). The risk for the company is that the population will remain under-educated and therefore poorly qualified to perform skilled jobs. The opportunity is that by helping to raise standards of education and training, the company will, over time, raise the performance standards of its work force.

- Similarly, there might be serious concerns for public health. A company with CSR concerns will need to consider health treatment for employees (and their families) and possibly for funding wider public health initiatives in the country. The risk from not trying to raise health standards is that there could be high levels of absenteeism in the work force. The opportunities from higher health standards are a more efficient work force.

- In some developing countries, there may be a culture of bribery and corruption, and senior figures may expect to receive payments for showing favours to foreign companies. As a good corporate citizen, our company should want to avoid offering and giving bribes. Bribery of foreign officials is, in any case, an illegal act for companies in many countries, including the UK. There could therefore be a risk that the company, by investing abroad, will be expected and encouraged to break the law in matters such as bribery.

- If the company invests abroad, it will almost inevitably be affected by local politics. We know that the country has a long-established despotic leader. Depending on the nature of the government and its political outlook, risks could include the threat of eventual nationalisation of the company’s assets. If there is an armed political opposition, the company may need to consider issues related to security and the protection of company employees and also trying to avoid ‘taking sides’ in any such conflict, in spite of pressures from the government to do so. We can certainly expect strong political pressure from the country’s leader and the board will have to decide how it should respond to this pressure as a ‘good corporate citizen’.
Environmental issues

There will also be environmental risks and opportunities to consider when developing our CSR policies in a developing country:

- The company is proposing to build and operate a manufacturing facility. Manufacturing operations involve the consumption of raw materials and parts and the company should consider its policies on the sourcing of these. A company with CSR concerns should not consume raw materials (such as timber) at a non-sustainable or wasteful rate. It should also avoid purchasing raw materials from suppliers who do not have sustainable business policies.

- The company should also try to ensure that the pollution created by its own manufacturing operations (air, water and land pollution) are all kept to a minimum and that systems for monitoring pollution (and setting targets for reductions in pollution over time) are designed and implemented.

- There may be extremes of weather in the developing country, for example, with risks from severe flooding. If so, our environmental policies should include measures for the protection of our operations and assets against risks from adverse climatic conditions.

Conclusion

This paper has simply set out a list of CSR issues that the board may need to consider. On our return from the fact-finding visit, we shall be able to present to you in much more detail the specific CSR issues that would face the company if the board decides to invest in that country.

Examiner’s comments

The question asked for a board paper but most candidates did not structure their answers in this way. A few answers were excellent, showing a good understanding of the issues and applying them to the scenario in the question. Weaker answers either lacked substantial ideas and consisted of general platitudes, or focused entirely on the humanitarian and environmental ‘good’ that the company should bring to the developing country – building hospitals and schools. Ethical issues were certainly involved in the scenario but not to the exclusion of commercial affairs.

5. Hans Denkmal (‘Hans’) is the chairman of Pindrop, a UK premium listed company. He is regarded by the investment community as a successful and competent chairman, partly because of his interest in best corporate governance practice. He has strong views about what the role of a company chairman should be, which correspond to the principles and provisions in the UK Corporate Governance Code.

A major problem has just arisen in his company, concerning the chief executive officer (CEO). The company has reported a big loss on a contract with a major customer, and a reason for the loss appears to be that much of the work on the contract was subcontracted to another company at a very high price, and the sub-contracting agreement was very unfavourable to Pindrop. The amount of work sub-contracted was very large. It has now been discovered that close family members of the CEO of Pindrop own more than 15% of the company that did the sub-contracting work. When challenged by Hans about this matter, the CEO denied any breach of duty or other wrongdoing. He added that if he was taken to court by the rest of the board of directors, or by a shareholder, he would defend himself vigorously and would expect to receive financial protection in these circumstances from the company’s directors’ and officers’ liability insurance.
Required

(a) Describe the role and accountabilities of the chairman of a listed company, with regard to board effectiveness and investors’ expectations of a successful and competent chairman.

(12 marks)

Suggested answer

The role and accountabilities of a listed company chairman are set out in the UK Corporate Governance Code (the UK Code) and in the FRC’s Guidance on Board Effectiveness. The role of the board is to provide entrepreneurial leadership for the company and a key role of the chairman is to provide leadership to the board. Investors will judge the success and competence of a chairman according to the effectiveness of the leadership that is provided.

A chairman is also expected to commit sufficient time to the company and investors will also judge him (or her) according to whether this time commitment seems sufficient.

A successful and competent chairman will be expected to carry out the roles specified in the UK Code. This describes the responsibilities of a chairman as follows, in relation to the role of the board. The chairman:

- Is responsible for leadership of the board of directors and for ensuring that the board is effective in all aspects of its role.
- Should set the agenda for the board and should make sure that sufficient time is made available for discussion of all items on the agenda, particularly strategic issues.
- Should promote a culture of openness and debate in board meetings. In particular, the chairman should facilitate effective contribution by NEDs and should try to ensure constructive relations between the executive directors and NEDs on the board.
- Is also responsible for ensuring that board members receive accurate, timely and clear information (and in this regard should be assisted by the company secretary).
- Should also ensure that there is effective communication and dialogue with shareholders.
- Should make sure that an effective decision-making process is in place in the board. The chairman should also make sure that the board committees are properly structured and that they all have appropriate terms of reference, so that they can operate effectively.
- Is responsible for the effectiveness of other board members, ensuring that directors are sufficiently knowledgeable about the company and involved in its affairs. The chairman should make sure that newly-appointed directors receive suitable induction and that all directors (including himself) receive suitable continuing development and training. The chairman should encourage the involvement of NEDs and the UK Code states that the chairman should meet occasionally with the NEDs without executive directors present.
- Leads the annual review of board performance and effectiveness and should act on the results of that review by recognising strengths or weaknesses in the board. Where appropriate, the chairman should recommend new additions to the board or should suggest that an existing board member should resign.
- Should try to develop a constructive relationship with the CEO, although, given the situation at Pindrop, this currently seems difficult.
Accountability

The chairman should be accountable to shareholders for his success (or failure) in creating an effective board. The accountability of the board as a whole to the shareholders is achieved through the annual report and accounts. The UK Code requires the board to report on its annual performance evaluation and, given the role of the chairman in this evaluation/review, the chairman is accountable through this part of the report. In addition, the preface to the UK Code states that chairmen are encouraged to report personally in their annual statements on how the UK Code’s principles relating to board effectiveness have been applied.

Examiner’s comments

Many candidates provided a reasonable or good answer to this part of the question, although many answers stated that the chairman was accountable to the shareholders without suggesting how he is made accountable. The board as a whole is accountable through the report and accounts and the AGM. Some candidates appeared to write everything they knew about the chairman of a board of directors, with the result that answers were presented in a long list of points, some relevant to the question and some not relevant.

(b) Explain, with reasons, whether the CEO appears to be in breach of his statutory duties as a director of Pindrop and recommend what action the chairman should take.

(9 marks)

Suggested answer

In UK law, directors have a statutory duty to avoid conflicts of interest. These are situations where the personal interests of the individual are different from (and opposed to) the best interests of his company, and the director would therefore have to choose between acting in his self-interest or in the interest of the company. It is almost certain that the CEO knew about the award of the sub-contracting work to a company in which his family members hold a substantial amount of shares and it is unlikely that the sub-contracting work would have been awarded without his approval. There was a conflict of interests because the agreement appears to have favoured the sub-contractor and might therefore not have been agreed on fair ‘arm’s length’ terms.

The CEO might argue that in this case he did not have a conflict of interests. However, it is also a statutory requirement in UK law (Companies Act 2006) that directors should declare any interest in a proposed transaction with the company. Because of the shareholding of family members in the other company, the CEO can be said to have an interest in the sub-contracting work, and he should have disclosed this interest to the rest of the board before the contract was made. He did not do this.

It is also possible that the failure of the CEO to disclose his interest on the sub-contracting work has led to a breach of the UK Disclosure and Transparency Rules. A related party transaction is a transaction between a company and a related party, other than in the normal course of business. For most related party transactions above a minimum size, a listed company is required to; make an announcement to the stock market giving details of the transaction; send a circular to shareholders giving more details; and obtain the prior approval of the shareholders for the transaction. It might be argued that the sub-contract was not in the normal course of the company’s business and so should have been reported and subject to shareholder approval.

In view of the possibility of legal action in this matter, the chairman should proceed carefully. It would be appropriate to take one or two individuals into his confidence – the company secretary and the senior independent director would be suitable for this. In confidence, the chairman should ask the company secretary to seek initial legal opinion about the current situation, to establish whether the CEO appears to be in breach of his statutory duties. His next step would then depend largely on the legal advice received.
Examiner's comments

Many candidates appeared to struggle to answer part (b), although there were some very good answers. The main weaknesses were to list all of the statutory duties of directors and then select duties that the CEO appeared to have failed to perform. Many candidates suggested that the CEO had failed to act with due care but did not provide convincing, realistic reasons for this view. Directors should avoid a conflict of interest. Even when they do not think that a conflict of interests exists, they should declare their interests in a proposed transaction to the board. Some candidates suggested that a conflict of interest for a director is acceptable provided that the board has given its approval, but this confuses two separate statutory duties. Only a few candidates appeared aware of the Disclosure and Transparency Rules on related party transactions.

A further weakness in many answers was a lack of caution in the recommendation about what should be done by the chairman: many candidates wanted the board to dismiss the CEO immediately. Less realistically, some candidates suggested that the chairman should call a general meeting to ask shareholders to dismiss the CEO.

(c) Explain the nature of directors’ and officers’ liability insurance and suggest whether this will protect the CEO financially against any legal action by the company against him for breach of statutory duty.

(4 marks)

Suggested answer

Directors’ and officers’ liability insurance (D&O liability insurance) is insurance purchased by a company to protect its directors and other officers against the cost of legal action for ‘wrongful acts’. In the UK, the UK Corporate Governance Code states that (for listed companies) the insurance should be ‘appropriate’, which should mean that the cover is sufficient to cover directors against all such costs and that the insurance covers all the costs that a director might occur as a consequence of such legal action.

However, D&O liability insurance does not cover a director against personal liability for illegal acts. If he is taken to court for an alleged breach of his statutory duties, the CEO would therefore not be covered against the cost of any fine imposed by the court in the event that he is found guilty. Similarly, if there is a civil action against him by the company or shareholders representing the company, it is unlikely that insurance cover would be available to cover the cost of any settlement awarded by the court. (D&O liability insurance might cover the cost of settlements in a civil action, but it is doubtful whether this would include legal action initiated by or on behalf of the company itself.)

Examiner’s comments

Most candidates answered this part of the question reasonably well or very well. A few answers did not explain what D&O liability insurance is and so did not answer the first part of the question.

6. The newly-appointed chairman of a UK premium listed company has asked the company secretary for his opinion and advice about a number of issues that are causing him some concern. He has discussed these concerns with the chief executive officer (CEO), but thinks that the CEO does not show enough concern for the risks, particularly in view of the fact that the company is in the process of preparing its annual report and accounts. The chairman mentions three issues in particular:

(i) He has been puzzled by the extent of the questions that the external auditors have been asking all members of the board about the going concern status of the
company. He thinks it may be because another client company of the audit firm went into liquidation unexpectedly a few months ago.

(ii) He has read reports in the financial media about the growing concerns of some institutional investors about the lack of reliability in the financial reports of many companies. As he is not an accountant, he is not sure what measures can be taken to make sure that financial reporting is reliable. He has tried asking the finance director, but could not follow all of the technical detail that he was given in reply.

(iii) Like many other company directors, he has become much more aware about reputation risk and its consequences, following the events in 2010 involving the tragic explosion and oil leakage at BP’s well in the Gulf of Mexico. The chairman thinks that his board should be giving much more attention to the implications of reputation risk for their own company.

Required

(a) Explain the nature of a going concern statement and the responsibility of the directors of listed companies in the UK for such a statement. 

(7 marks)

Suggested answer

A going concern statement is a published statement by the board of directors of a company, asserting that the company will remain in business and continue to trade for at least a given period of time, and will not become insolvent or go out of business for any other reason during that time. The company’s financial statements are therefore prepared on a going concern basis and assets valued accordingly, instead of at their ‘break-up value’.

The UK Corporate Governance Code includes a provision that the directors should report in the company’s annual and half-yearly financial statements that the company is a going concern, ‘with supporting assumptions or qualifications as necessary’. The UK Listing Rules also require the directors to make a statement in the report and accounts that the company is a going concern, together with supporting assumptions and qualifications as necessary.

The directors may be personally liable if they make a statement that the company is a going concern without giving the matter careful consideration. Such a liability could arise if the company subsequently goes into liquidation within 12 months of the publication of the statement.

Accounting standards also require directors to make a going concern assessment and to disclose the nature of any material uncertainties they might have about whether the company will be able to continue as a going concern.

Guidance to directors (and audit committees) has also been provided in the UK by the FRC. The FRC recommends that directors should make and document a rigorous assessment of the company’s going concern status when preparing the annual and half-yearly financial statements. During periods of economic uncertainty, it is particularly important for audit committees and boards of directors generally to assess their company’s going concern status very carefully and should not recklessly or deliberately provide misleading information about this matter to shareholders.

Examiner’s comments

In general, this part of the question was answered fairly well.
(b) Explain the various measures that are taken to provide reliable financial reports to shareholders, or improve the reliability of financial reporting.  

Suggested answer

A variety of measures may be taken to provide reliable financial reports to shareholders:

- The accounting profession should promote reliable financial reporting through financial reporting standards. Ideally, there would be a single set of accounting standards that applies globally, so that all large companies produce financial reports using the same principles or rules, but this ideal situation does not yet exist.

- The independence and conduct of audit firms is important for financial reporting because investors may rely on the opinion given by the auditors in their audit report on the accounts of a company. The auditors should argue against accounting policies or estimates used by management in their draft financial statements and be prepared to qualify their audit report, if necessary, in the event of continuing disagreements with management.

- The auditors must remain independent from management. To a large extent, the impartiality and professional conduct of auditors is promoted through the rules and ethical guides of the profession.

- A board of directors (through the audit committee) should also monitor the independence of the company’s auditors, for example, by reviewing the conduct of the annual audit. There should also be a policy on giving non-audit work to the external audit firm, as part of the objective of preventing loss of auditor independence.

- To a large extent, the reliability of financial statements depends on the quality of the system of internal financial controls. The board has a responsibility to review the effectiveness of these controls each year, and the external auditors will review the controls as a part of their audit and report any perceived weaknesses in their report to management and the board.

- One way in which the audit committee might monitor the annual audit and the conduct of the external auditors would be to ask the internal audit department to carry out a review of the annual financial statements and the report to management by the external auditors (as part of the annual audit process).

- The board of directors should try to promote transparency in all reporting by the company to shareholders and other stakeholders. Transparency means making the position or intentions clear and not hiding information. Shareholders are likely to trust the financial statements of a company whose board they consider to be open and fairly honest.

- Directors should be made liable, and aware of their liability, for misleading financial reporting. The potential liability for lack of care in preparing a going concern statement has already been mentioned. The US has more stringent requirements under the Sarbanes-Oxley Act. The CEO and Chief Financial Officer (CFO) of companies registered with the SEC are required by the Sarbanes-Oxley Act (section 302) to provide a signed certificate vouching for the accuracy of the information in the company’s financial statements. This makes the CEO and CFO potentially liable personally for the accuracy (and reliability) of the financial statements.

Examiner’s comments

Concerns about poor corporate governance emerged in the UK in the 1980s as a consequence of cases of misleading financial reporting by some companies, and the losses from the resulting unexpected corporate failures. Candidates should therefore have been aware of the governance issues surrounding reliable financial reporting. Some candidates provided good answers but
many answers lacked breadth and understanding. Some confused ‘reliability’ with ‘understandability’. Some answers did not mention the role of the external auditors, which was surprising.

(c) Using the example of BP, or any other example with which you are familiar, explain the possible implications for a major global company, and the possible consequences, of an event that causes serious damage to a company’s reputation. 

(10 marks)

Suggested answer

Answers to this part of the question varied according to the example used by candidates. The question required a considered (but brief) discussion of the potential consequences for a company of a possible future event that could cause severe damage to the company’s reputation.

The ‘oil spill’ in the Gulf of Mexico, and associated events, had a number of implications for BP (‘the company’). These events damaged the company’s reputation, but there were other associated consequences that might therefore be associated with reputation risk:

- The company came under strong political pressure from the US Congress and administration. Comments and opinions from politicians added to the damage to reputation. The US administration reportedly persuaded the company’s board to defer any dividend payments to shareholders because of the cost of clearing up the damage caused by the accident and the cost of compensation payments.

- The political damage had implications for legal and regulatory actions against the company, which faced the risk that it might be prohibited from engaging in future business activities in the US.

- There were also legal implications from the cost of compensation to individuals and organisations that suffered losses as a consequence of the oil spillage. The cost to the company was estimated in tens of billions of dollars.

- The legal implications had a knock-on effect for the financial risks and business risks facing the company. The company needed to obtain cash to make the compensation payments it faced (and create a fund for these payments). There were also rumours in the financial press that the company’s financial weakness might make it vulnerable to a takeover bid.

- The incident may well have had implications for the company’s reputation for both safety concerns and environmental concerns. The company may have spent time and money (before the accident) developing its reputation in these areas. The effect of the oil leak might be to make the company re-consider both its safety procedures (risk management systems) and its public relations and advertising/marketing policies.

- There may also have been some consequences for employees of the company, who might have had to change their views of the environmental ‘friendliness’ of the company and some public hostility to their company. This would affect the views of the company they work for and possibly weaken their loyalty to the company.

- The views of investors in the company might be affected by a change of view about its ‘environmental friendliness’, as well as changes in its dividend policy and share price.

- There might also be consequences for the company’s brands and sales of its products, particularly in the US where the environmental impact was felt.
Note: Answers should have shown an understanding of implications for the company that might be associated with ‘reputation risk’ and other views and approaches were equally acceptable.

**Examiner’s comments**

Answers to this apart of the question varied considerably in quality, partly due to the fact that many candidates answered this as their fourth question and appeared to be running out of time. Weaker answers focused on damage to reputation, to the exclusion of everything else, and so did not fully answer the question.