Corporate Governance
November 2012

Suggested answers and examiner’s comments

Important notice

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

Examiner's general comments

The quality of exam scripts for the November 2012 session was largely not very high. A number of answers included elementary errors of fact and detail, indicating that candidates had not prepared sufficiently for the exam. For example, many answers did not state correctly the UK Corporate Governance Code provisions for the composition of a board of directors or a remuneration committee, or did not clearly state the role and responsibilities of a nomination committee and its chairman.

Comments on past exam papers have highlighted general weaknesses in scripts and reasons why some answers did not achieve a pass standard. All of the regular weaknesses were in evidence again, indicating that the feedback on past exam sessions had not been reviewed by many candidates. Before looking at the suggested answers to the questions in the November 2012 exam, it may be useful to look at some comments that have been made in the past and how candidates in November 2012 have compared.

(i) In November 2012, there was a 6 mark question on the role of a risk committee in a company such as a bank and most candidates who answered this question wrote about the responsibilities of the committee for identifying risks, evaluating risks and implementing controls. However, a comment on the June 2012 paper was as follows: “Most candidates will not have much (or any) experience with the workings of a board of directors and, as a result, there are many misconceptions and misunderstandings about what the board and its committees actually do. It is important to understand that a board of directors is not an executive management body, even though some of its members are executive directors. In the area of risk management, the board sets the overall policy on risk and must review the effectiveness of the risk management system to satisfy itself that the system is effective. However, the board does not have the task of identifying risks, evaluating risks and implementing controls and other risk management measures.”

(ii) Another comment on the June 2012 paper was: “Some candidates clearly showed that they had learned the UK Corporate Governance Code in detail, and were given due credit. However, too many candidates did not appear to know much (or any) of the UK Corporate Governance Code,
but attempted answers to questions … that made specific reference to it. Candidates would be well advised to study the UK Corporate Governance Code as part of their preparation for the examination.” In November 2012, there were questions that required knowledge of the UK Corporate Governance Code with regard to the composition of the board of directors and the composition and responsibilities of the remuneration committee. These were popular questions but many answers included incorrect facts about the UK Code.

(iii) It is understood that most candidates taking the Corporate Governance exam have not yet had direct experience of activities at board level within their organisation. As a result, they may not know how boards and board committees ‘work’. Even so, candidates are expected to show some practical awareness. For example, in answer to Question 1(a) in November 2012 (where candidates were asked to recommend measures for improving communications between the board committees and the board) sensible answers suggested that the minutes of committee meetings, taken by the company secretary, should be circulated to all members of the board so that they are made aware of what each committee has been doing. Weaker answers commented, if they identified the point at all, that they would ‘ensure’ that communications between committees and the board would be improved, without giving any suggestion how this ability to ‘ensure’ would function in practice. These statements need to be fully explained in order to achieve marks. Another example was a question asking candidates about measures to ensure compliance by directors with the Model Code on share dealing. Sensible answers included suggestions that directors should be informed that they must not deal in shares at any time without the permission of the chairman, and given a copy of the Model Code (or company) rules. Weaker answers suggested, for example, sending directors on a training course to learn the rules. It is unlikely that a company would waste time and money unnecessarily on a training course of indeterminate duration to convey the message on some basic rules and requirements. When candidates learn Corporate Governance, they should try to think about the practicalities of how things should be done.

Common weaknesses in exam technique that have been explained in past suggested answers were again demonstrated in the scripts of most candidates in November 2012. These weaknesses mean that candidates spend time writing comments that are not given credit and this is a waste of valuable exam time. For example:

(i) It was stated in the June 2012 suggested answers that: “It is essential to answer the question that has been set, not what you would like the question to be about. There is a tendency for some candidates to write about a corporate governance topic rather than answer the question that has been set. It is important to focus on the actual question, and present a sufficient number of relevant ideas and points. These earn marks: irrelevant comments about a topic do not.” Far too many candidates in November 2012 wrote an answer which did not answer the question set and did not therefore earn marks.

(ii) Candidates have also been advised against using very brief bullet points to make points in answer to a question. The following comment was made about the June 2012 paper: “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 adequately explained.” However, many answers were again presented in brief bullet point notes that were insufficient and inadequate to fully explain the points being made. This applied to answers to Question 5 in the November 2012 paper in particular, as many answers did not fully or clearly explain the points being made and relied instead on incomplete bullet points and ‘shorthand’ comments.

(iii) Time allocation between questions continues to be another problem. Many candidates wrote at length in answer to the first question they selected, then slightly less on the next question. After that, it appeared that many candidates realised they were now short of time and therefore had to rush their final two answers. Even if they earned pass marks for their first two answers, these would be offset by poorer marks for the final two answers and the overall result, more often than not, would not achieve a pass mark. It has been suggested to candidates in the past that it can
be useful to plan an answer for a short time before starting to write, so that they can identify the points they intend to make and check whether they have enough ideas to earn the marks for the question. This means for example that, in answering a 12 mark question, two minutes noting points for an answer may help candidates to think of, say, 6 or 7 points. Candidates can then write an answer knowing that they have about 15 minutes to write on those 6 or 7 points, and can keep an eye on the time in order to complete an answer within the time available – and then move on to the next question. It seems that candidates for the Corporate Governance exam either do not write an answer plan at all – and so tend to repeat the same point in their answers, often with a lack of detail – or in some cases write such lengthy answer plans that they run out of time for their actual answer.
1. You have just been appointed as the company secretary to Blok plc (‘Blok’), a UK listed company, and you have already identified several problems that require your attention.

From discussions with some of the directors and senior managers, you have learned that communications at board level are poor. Committees sometimes make decisions without first referring the matter to the board and the board is not always aware of what the committees have been discussing. Non-executive directors (NEDs) also complain that they know very little about business operations because they find it very difficult to get useful information from the executive management team.

One of the executive directors has expressed an opinion to you that some NEDs are not properly independent, and almost invariably give their full support to the chairman in boardroom discussions. The executive director had raised the matter in a private conversation with the chairman, but was told there was nothing to be concerned about.

You are also aware that the directors may not be properly aware of the rules relating to the sale of shares in the company. Recently, one of the executive directors sold a substantial number of shares during a close period and was subsequently reprimanded by the chairman.

Required

(a) Explain your responsibilities as company secretary for the problems of communication and decision-making that you have identified, and suggest the measures that you should take to help improve the problems at Blok.

(12 marks)

Suggested answer

The UK Corporate Governance Code states that the company secretary should provide advice to the board, through the chairman, on corporate governance matters. It is therefore the responsibility of the company secretary to bring problems with corporate governance to the attention of the chairman, with a view to having the matters discussed and resolved by the board.

Communications at board level at Blok are poor. The particular problems that have been identified are the poor flow of information between the board committees and the board, and the lack of information made available to the NEDs. A function of the company secretary is to contribute to the flow of information and the company secretary therefore has a responsibility to deal with this problem.

The company secretary also has a responsibility to ensure compliance by the company with laws and regulations. The recent breach of the Model Code and DTR reporting regulations by an executive director should be attributed partly to a failure by the company secretary to make the director aware of his duties and obligations with regard to dealing in the company’s shares.

Measures to improve problems in communications

Communications between the board committees and the board are unsatisfactory. It is also possible that communications between the board committees is also inadequate. The company secretary, or an individual from the company secretary’s department, should act as secretary to the board committees. A responsibility of the secretary to the committees should be to ensure that deliberations by the committees are reported to the board. This should be done formally through the copying of committee minutes to board members (or a summary of committee meetings in the papers for board meetings).

As secretary to the board committees, the company secretary should write full explanatory minutes of committee meetings that state clearly the issues that were discussed and the
decisions that were reached. These minutes should be written and distributed to board members as soon as possible after the meeting has taken place.

The company secretary should also advise the chairman of the board to ensure that feedback from the committee chairmen is included on the agenda for board meetings, so that the rest of the board have an opportunity, as a regular item of business, to ask questions and make comments.

The company secretary should also try to ensure that informal communications are also effective, and that issues considered by the board committees are communicated to other individuals on the board who should be kept fully informed – notably the chairman, the CEO and (for matters relating to audit and financial risks) the finance director.

NEDs have complained about their lack of knowledge and understanding of the company’s business. The NEDs should have expressed their concerns much more forcibly, because they have a responsibility to make sure that they are adequately informed. However, the company secretary is an important point of contact for the NEDs and should make arrangements to provide NEDs with the knowledge that they need. This can be achieved partly by ensuring that the NEDs receive sufficient induction on appointment, and sufficient continuing development or training after appointment. Site visits and meetings with executive managers could be arranged, as part of the ongoing development of the NEDs.

The company secretary should also arrange for NEDs to meet with executive managers, both informally and as part of a formal training and development initiative. Meetings should help to improve the understanding and trust between NEDs and executives, as well as giving NEDs the opportunity to ask questions and learn more about the business. Relations between the executives and NEDs could also be improved through social time spent together, for example, at board lunches or dinners that the company secretary could include on the annual board calendar.

Measures to improve problems in decision-making

Board committees should not act outside their terms of reference, but the board committees of Blok sometimes take decisions without informing the board. It is therefore possible that committees may be taking decisions that ought to be referred to the full board for decision-making. The company secretary should take two measures to deal with this potential problem.

The committees, and in particular the committee chairman, should be reminded about the terms of reference of their committee, and the matters that the committees should refer to the board for decision. As secretary to each committee, the company secretary should ensure that none of them exceeds its authority. The terms of reference for each of the board committees should be reviewed annually, to ensure that it remains appropriate.

The company secretary should also help the board chairman to produce a list of matters reserved for decision-making by the board. This should be discussed and agreed with the board, and the agendas for board meetings should be prepared with this list of matters in mind.

(b) Provide an appropriate response to the suggestion by the executive director that some NEDs may not be independent.

(5 marks)

Suggested answer

The UK Corporate Governance Code includes a list of criteria that should be used for assessing the independence of NEDs. As a general guide, for example, individual NEDs should not be considered independent if they have been an employee of the company within the past five years, or if they have a material business relationship with the company, or if they represent the interests of a significant shareholder. The executive director does not appear to be suggesting
that any NEDs breach these independence guidelines, although one or more of the NEDs may have been on the board for over nine years and so may be considered ‘not independent’ under the nine-year guideline.

The concern of the executive director seems to relate to the independence of mind of some NEDs, and the tendency of the NEDs to give unquestioning support to the chairman in board discussions. The concerns of the executive director should be given serious consideration. It is quite possible that some shareholders may have their own concerns about a compliant board.

The company secretary should discuss the matter with the chairman, who is accountable for the board’s performance. The chairman might be encouraged to facilitate wider debate at board meetings from individual executive and non-executive directors to demonstrate a more balanced approach to decision-making.

A useful focal point for the discussion might be the annual performance reviews of the directors. As a part of these reviews the contribution of each director to the deliberations of the board should be considered. The assistance of external facilitators may help to assess whether NEDs are sufficiently independent-minded and are making valuable contributions to the board. If any individual NED is considered to be contributing too little, he should be asked to resign or, at the least, should not be offered an extension of their contract at the end of their current three-year period.

(c) Describe the rules relating to dealings by directors in the shares of the company, and indicate the steps you should take to try to ensure compliance.  

Suggested answer

Blok is a UK listed company, and must comply with the Listing Rules and the Disclosure and Transparency Rules (DTR). The Listing Rules contain a requirement that companies must have rules on share dealings by directors (and connected persons) that are no less stringent than the rules in the Model Code. The purpose of the Model Code is to ensure that directors do not abuse (and do not put themselves under suspicion of abusing) inside information, especially during a period leading up to the announcement of company results.

The Model Code therefore requires that directors should not deal in shares of their company in the two months prior to the announcement of company results (close periods), or at any other time when they have price-sensitive information.

Directors must also seek permission from the board chairman (or another designated board director) before dealing in shares of the company. The director (as a ‘person discharging managerial responsibilities’) is required by DTR to notify the company of any share dealings and the company must notify a Regulated Information Service (RIS).

The recent sale of shares by the executive director was a serious breach of the rules. A reprimand from the chairman would seem to be an insufficient response. However, the reason for the sale of the shares by the director is not yet known, and the appropriate response will depend to some extent on the intent of the director, as well as any personal financial gain that the director may have obtained from the share dealings and subsequent movement in the share price. If there is a suspicion of deliberate insider dealing, the consequences could be very severe.

To ensure compliance with the rules, the first step should be to establish whether the listing authorities have been notified of the breach and whether the share dealings have since been notified to an RIS. It is essential to disclose all the necessary information. The board will also have to respond to any requirements of the listing authorities, who will be expected to investigate the matter.
To improve controls within the board, all directors must be reminded of their duties and obligations with regard to share dealings, and it should be suggested to the chairman that any further breach by a director in the future would be dealt with by disciplinary action – probably a request for the individual to resign from the board and to require the director to donate any gains made from improper share dealing to charity.

It would also be appropriate for the company secretary to remind directors of the rules at any time that the company is entering a close period for share dealings by directors.

**Examiner's comments**

**Part (a)** In view of the problems experienced with communication in the company, it is surprising that very few answers suggested that the company secretary may be partly or wholly responsible for the problem.

Many answers included comments that were inappropriate for this question or were not fully explained. For example, many candidates began by stating that the company secretary acts as the ‘conscience of the company’ – a description that applies to the role of persuading the board to act ethically and in compliance with rules and guidelines. It has no clear connection with communication, and no candidates attempted to explain what the connection might be.

Far too many candidates stated that they would take measures to ‘ensure’ that the problems would be resolved, without explaining what these measures might be.

A popular measure given was to ‘ensure’ that an agenda is sent to board members in advance of board meetings, but it is difficult to see how an agenda of items for discussion or decision-making can be of significant practical value, given that it would be most unusual if an agenda were not already sent out in advance of board meetings.

Many candidates identified ‘induction’ as a method of improving the understanding of the business by NEDs but many of these answers did not demonstrate an understanding of what induction means. It means ‘leading in’ and refers to measures for introducing new directors into an understanding of their roles and responsibilities when they first join the board. Answers referred to induction when discussing further training or familiarisation measures for existing NEDs.

**Part (b)** Many answers did not go any further than listing the criteria in the UK Corporate Governance Code for judging the independence of a NED, and suggesting that NEDs who did not seem independent should be asked to resign from the board. This type of answer did not recognise the concern at the heart of the question – that the NEDs were allegedly taking the ‘side’ of the chairman in board discussions and that they may therefore be failing to think and act independently.

**Part (c)** By far the most common error here was to confuse the Model Code for share dealings by directors with the insider dealing laws in the Criminal Justice Act. These are different, but not in any way contradictory. This confusion led some candidates to suggest that dealing in a close period was insider dealing and a criminal offence, but allowable under certain circumstances of financial hardship. Answers needed to show more knowledge and better preparation for this topic than was shown in the answers provided.
2. Robert Brack (‘Robert’) is the chairman of the nomination committee of Plot plc and is also chairman of the audit committee. He thinks that the composition of the board should be changed. In his view, the board should consist mainly of non-executive directors (NEDs), and there is no requirement for executive directors on the board except for the chief executive officer (CEO) and finance director. The approaching retirement of the CEO, in Robert’s view, presents an excellent opportunity to reduce the number of executive directors by promoting the operations director, currently a board member, to the position of CEO. The new operations director need not be offered a board position.

Robert is also concerned about the lack of diversity on the board, and believes that most of the current NEDs should be replaced, and that there should be an increase in the number of female board members.

The chairman of the board, Timothy Morgan (‘Tim’) has different views. He thinks that the current balance of the board, with a small majority of independent NEDs, is suitable. In his view, the operations director would not make a suitable CEO. He also believes that it is inappropriate to ask NEDs to resign before the end of their three-year appointment period, and that it would be madness to appoint women to the board just for the sake of being seen to be progressive.

Robert and Tim have had heated arguments about their differing views. Robert believes that poor-performing NEDs should be told to resign and that, as chairman of the nomination committee, he should have more authority than Tim on matters of board appointments and succession. Tim believes that Robert should not be chairman of two board committees, and that a suitable way forward would be for himself to replace Robert as chairman of the nomination committee.

Tim has asked for your opinion, as company secretary, about the differences of opinion between himself and Robert.

Required

Prepare a report for Tim, the board chairman, in which you:

(a) Explain the role of the nomination committee chairman and suggest whether it is the nomination committee chairman or the board chairman who should have authority to deal with matters concerning the composition of the board and board succession matters.

(9 marks)

(b) Recommend measures that might be taken to review and change the composition of the board.

(11 marks)

(c) Advise on whether it would be appropriate, and within the provisions of the UK Corporate Governance Code, for the chairman of the board to replace Robert as chairman of the nomination committee.

(5 marks)

(Total: 25 marks)
Suggested answer

To: Board chairman  
From: Company secretary  
Date: 29 November 2012

Subject: Composition of the board and nomination committee chairmanship

(a) Decisions about the composition of the board

I understand that there is some disagreement about the respective roles of the board, board chairman and chairman of the nomination committee in the matter of deciding the composition of the board.

Decisions about the composition of the board should have the full support and approval of the entire board, but it may be useful to look at the roles and responsibilities of the nomination committee and the board chairman.

The UK Corporate Governance Code (‘the UK Code’) states that the nomination committee should ‘lead the process’ for board appointments and should make recommendations about appointments to the board. However, the power over board appointments should rest with the whole board.

Recommendations about specific board appointments should not be the exclusive right of the board chairman or CEO, but the chairman has a responsibility for ensuring that the composition of the board meets the expectations of the UK Code for good governance.

The need for a new board appointment is not decided by the nomination committee. The board makes a decision about the need for a new appointment, and the matter should be put on the agenda for a board meeting by the board chairman. Responsibility for seeking for an individual to be appointed should be delegated to the nomination committee, which should make a recommendation to the board.

The disagreement between yourself and the chairman of the nomination committee is unfortunate, but it is important to recognise that neither individual has exclusive responsibility for board composition or board appointments. I make some recommendations in the next section of this report.

(b) Recommended measures for reviewing and changing composition of the board

The chairman of the board is responsible for reviewing the composition of the board. The views of other individuals should be taken into consideration, and these include the views of the chairman of the nomination committee.

The board chairman should also review the size and composition of the board as part of the annual performance review of the board, its committees and its individual directors.

The CEO will soon retire and the nomination committee has a responsibility to consider succession planning, and make recommendations for a replacement. It is appropriate for the nomination committee to recommend the current operations director as an eventual replacement. Although the board chairman does not agree, the recommendation should be discussed with all board members. These discussions should initially be in confidence, to avoid unnecessary upset and offence to the current operations director. If the other board members agree with the board chairman that the operations director would not make a suitable CEO, the nomination committee should be asked to carry out a search and come up with a different recommendation.
The board chairman should also discuss the size and composition of the board with the other directors, and the suggestion to reduce the number of executive directors should be considered. The board chairman should express his views, but the views of the nomination committee chairman should also be discussed.

The UK Code states that the search for board candidates should be conducted, and appointments should be made on merit, against objective criteria and with due regard to the benefits of diversity, including gender. This suggests that the nomination committee chairman is correct in arguing for greater diversity, and the appointment of more women to the board. This has been recommended more specifically in Lord Davies’ report (2011) which stated that gender-diverse boards have a positive impact on decision-making and performance, and that when women are under-represented on boards, companies are not drawing from the widest range of available talent. The report recommended that the UK Code should include a requirement for companies to establish a policy on boardroom diversity. The report also recommended that FTSE100 companies should aim for board membership to consist of at least 25% women by 2015 and that all chairmen of FTSE350 companies should set out the percentage of women they aim to have on their boards in 2013 and 2015.

In addition to the need for gender diversity, it is also appropriate to consider the benefits of diversity in the ethnicity of board members. This requirement is already recognised by international companies, where ethnic diversity is essential for a proper understanding of the industry, markets and customers.

Any resistance to the need for change is therefore not appropriate.

The board and its committees should be continually refreshed. Although the nomination committee chairman may be unreasonable to expect that most current NEDs should be replaced now, the need for refreshing board membership over time is essential and the requirements of the UK Code for diversity should be taken into account in widening the search beyond the ‘usual suspects’, not only female candidates but also those with experience in other sectors. This will bring fresh perspectives and challenge to the board’s decision-making.

Decisions about whether to ask poor-performing directors to resign should also be considered as part of the annual performance review of the board.

As part of its responsibilities for reviewing the composition of the board, the nomination committee also has an ongoing role in succession planning, which is significant for the composition of the board and future changes in its membership.

The overall objective should be to follow established procedures for review of board composition and membership, and both the board chairman and the chairman of the nomination committee should recognise that they do not have exclusive responsibility for these matters.

(c) Chairmanship of the nomination committee

The UK Code states that the chairman of the nomination committee should be either the board chairman or another independent NED. It is therefore acceptable for the board chairman to be the nomination committee chairman too, except when the committee is seeking a new company chairman.

A decision about whether the composition of the committees should be changed ought to be a matter for board discussion and agreement.

If the board chairman and nomination committee chairman disagree about the need for change, the disagreement should be given full airing and discussed rationally. This is probably best done with the Senior Independent Director who could be tasked with making a recommendation to the board.
Other board members may consider, for example, that the same individual should not be chairman of both the nomination committee and the audit committee, because of the demands on the individual's time and also to avoid over-reliance by the board on one individual NED. A decision to appoint a new nomination committee chairman might therefore be a sensible one.

**Examiner's comments**

**Part (a)** Most candidates, in their answers to part (a), (b) or (c), attempted to explain the UK Code provision about the composition of a nomination committee. However, a very large proportion of answers did not explain this correctly.

Answers to part (a) should have included a straightforward explanation of the roles of the nomination committee and its chairman, but many answers did not explain this clearly or accurately. Some candidates referred to the responsibility for succession planning, but it was apparent from their brief comments on this point that they were not sure what succession planning is. There is a difference between taking measures to fill a vacancy at board level when it has arisen, and planning in advance for vacancies that will arise at some time in the future (which is succession planning).

There are no ‘hard and fast’ rules about who is responsible for carrying out the annual performance review of the board, its committees and its directors. However, many answers asserted that this was a responsibility for the nomination committee, and this suggested that candidates had not considered how the committee might therefore review its own performance and the performance of its individual committee members.

**Part (b)** The main weakness in answers to this question was not recognising that the question was about how to review the composition of the board with a view to continual change and refreshment. The question scenario gave strong hints about issues that could be discussed. Many answers incorrectly stated that the board should consist of equal numbers of executive and non-executive directors and then went on to discuss measures for bringing the numbers for this company into equality. A lot of candidates did not state that, in a large UK listed company, at least half the board, excluding the chairman, should consist of independent NEDs.

A few candidates suggested that executive directors were needed on a board of directors in order to manage the company. This was a fundamental error and misunderstanding of corporate governance. A board of directors delegates most executive decisions to the executive management team, and reserves a few decisions to itself. However, the board is not a management body and its function is not to make management decisions. Executive directors are useful for a board of directors because of their knowledge of the company's affairs: they are not appointed as directors to run the company. They are employed as 'executives' to run the company.

The question asked for a report, and credit was given for candidates who presented their answers in a form that resembled a report. Many answers were not presented in the required format.
3. Cobber plc (‘Cobber’) is a large UK listed company, operating in the transport business. It has been producing an annual social and environmental report (‘S&E Report’) for several years. One of the items on the agenda at a recent board meeting was a proposal to review the content and presentation of the report, following criticism from several shareholders that it lacked transparency, and contained too much narrative and not enough quantitative information about objectives and performance. One of the criticisms was that much of the information in the S&E Report was ‘cherry-picked’ and that the report presented only favourable information about performance and not the weaknesses and failures. Several shareholder groups have been putting pressure on the chairman and CEO to improve the quality of the S&E Reports that Cobber produces.

The board members agreed that other listed companies now produce much more detailed and balanced information in their S&E Reports, and that Cobber should consider improving its own report. One suggestion at the board meeting was for a sustainability report (or triple bottom line report). Another suggestion was that the report should follow the Global Reporting Initiative (GRI) Framework. A third suggestion was that integrated reports should be considered, as recommended by the King Code in South Africa.

There was general speculation that S&E reporting might eventually be made a regulatory requirement, but that regulation would be too heavy-handed and unnecessary.

As company secretary, you attended the board meeting and heard the views of the board members. At the end of the discussion, the board chairman asked you to report to the board on the matters that had been discussed, and to put forward proposals for the board to consider at its next meeting.

Required

Prepare a report for the board of Cobber in which you:

(a) Explain the reasons why social and environmental reporting by listed companies has become common, and the reasons for the pressure on the board to improve the reports produced by Cobber.  

(8 marks)

(b) Explain the nature of sustainability reports, the GRI Framework and integrated reports. Suggest how more information about social and environmental risk and quantitative measures of social and environmental performance might be included in the reports produced by Cobber. 

(11 marks)

(c) Describe the current regulatory requirements for disclosures of social and environmental information by UK listed companies in their published financial statements, and advise on the adequacy of these requirements. 

(6 marks)

(Total: 25 marks)
Suggested answer

To: Board of Cobber
From: Company secretary
Date: 29 November 2012

Subject: Social and environmental reporting

(a) Pressures for improvements in social and environmental reporting

Many listed companies now produce separate social and environmental reports. There are several probable reasons for these developments. Most significant is the growing demand from stakeholders in companies for more information about these matters. Stakeholders include not only shareholders, but also employees, the investment community, customers and suppliers, as well as government and the general public.

Companies may also consider that competitive advantage can be obtained, both from recognising the significance of social and environmental concerns, opportunities and risks, but also from reporting on these in a transparent way.

Many institutional investors have socially responsible investment policies, and so want to know more about the social and environmental policies and activities of companies in which they invest. Some major customers – both companies and governments – now have ethical buying policies and will not buy goods or services from suppliers whose social and environmental policies they consider to be unethical.

There also appears to be greater acceptance of an enlightened shareholder approach to corporate governance, and recognition by boards of directors that companies have certain obligations to stakeholders other than the shareholders. Companies are therefore more willing to provide social and environmental information, in response to the demand.

In many large companies, the boards of directors recognise the ethical responsibilities of companies to employees, the community in general and the environment, and therefore recognise the benefits of reporting on these matters, both internally (for example, in the form of environmental management accounting reports) and externally.

The pressure to improve the quality of reporting by Cobber appears to arise from a view that Cobber’s reports are biased, lacking sufficient details and omitting relevant information that users want to know. We have been criticised for lack of transparency in our S&E reporting, and for reporting only the aspects of performance that show the company in a favourable way.

The reports produced by Cobber are non-standard in form and content, but progress has been made towards standardisation of reporting, and stakeholders may expect Cobber to follow this trend.

Many companies currently use the GRI Framework for sustainability reporting, although differences exist in the detailed content of reports because sustainability issues and risks vary between different industries.

It should be noted by the board that many larger companies now make investor presentations on social and environmental issues, and the board may wish to consider whether this would also be appropriate for Cobber, to supplement improvements in its S&E Reports.

(b) The format and content of S&E reports

Several suggestions have been made about the format of S&E Reports.
Sustainability reports present the performance of a company from three perspectives: an economic perspective, a social perspective and an environmental perspective. For many companies, the social perspective focuses to a large extent on the company’s policies towards its employees and its employment objectives and achievements.

Sustainability reports combine qualitative and quantitative assessment or measures of performance. They explain the social and environmental policies and objectives of the company, and report on actual performance and progress towards achieving those objectives. Quantitative objectives and measures may be presented as key performance indicators.

The GRI Framework is a framework for sustainability reporting. It is a voluntary framework that has been adopted by a number of global companies. Its main feature is that it provides a standardised structure for sustainability reporting. GRI also recommends key performance measures that may be reported in different industries. Standardisation of reporting makes it easier for users to make comparisons.

Integrated reporting is a feature of the King Code in South Africa. An integrated report is a report that combines financial reports with social and environmental performance reports.

**Reporting by Cobber**

There is demand for Cobber to include more about social and environmental risks and more quantitative measures in its S&E reports. To do this, the board needs to consider the risks that it faces, its social and environmental objectives and policies for achieving them. Having established policy objectives, the company should then identify quantitative targets for achievement, and should establish a system for measuring actual performance in terms of these performance indicators.

Cobber is in the transport business and a significant risk will be the rising cost of fuel and the development of alternative technologies for transport, particularly road transport. There may be a threat of government regulation to restrict CO₂ emissions by transport vehicles, and both competitive and regulatory pressures may therefore oblige Cobber to consider its longer-term strategy for the composition of its road transport fleet.

There may also be the prospect of a significant shift between alternative forms of transport: road, rail and air, and Cobber will need to identify new trends and respond to changes in the market. Cobber’s sustainability reports should also include quantitative targets and measures of actual performance. A number of quantitative measures are used by other companies. Some are recommended by GRI. There are also techniques for converting some measures, such as quantities of oil consumed in motor vehicles, into a more universal measure of environmental emissions (tonnes of carbon dioxide emitted, for example). As a transport company, Cobber may consider reporting its carbon dioxide emissions and also the quantities of emissions of metals or other pollutants into the atmosphere. The actual measures of environmental performance used by Cobber should be relevant to the business of the company.

Quantitative measures of social performance may also be identified, consistent with the company’s policies towards its employees and the community. In a transport company, for example, health and safety issues should be a matter of some importance and the company may monitor progress towards the objective of zero accidents involving employees or customers.

**Regulatory requirements for disclosures**

In the UK, there are some regulatory requirements for disclosures of social and environmental information in financial reports and accounts.

The Companies Act 2006 (section 417) requires companies to include a business review in their annual report and accounts. This should include a description of the principal risks faced by the
company and the trends and factors that are likely to affect its future development. Information should be provided on environmental matters, including the company’s impact on the environment, and also on social and community matters. The report should provide information on the company’s policies on these matters and their effectiveness.

Although the report is mainly in narrative form, quoted companies are required to include key financial performance indicators and, where appropriate, key non-financial performance indicators, including indicators relating to social and environmental matters.

It is difficult to comment on the adequacy of these requirements without making judgements about the amount of social and environmental information that should be reported. A weakness of the Companies Act requirement is that it encourages long narrative reporting by companies, with only limited quantitative performance measures. This probably explains the continuing demand for S&E Reports by shareholders and other stakeholders.

The board should be aware of important international developments in integrated reporting that will probably affect the UK in the future.

In South Africa, the King III Report requires companies to integrate sustainability reporting and disclosures together with the company’s financial results and boards are responsible for ensuring the integrity of this integrated report, including the disclosures about sustainability. The report must also consider risks, and include forward-looking as well as historical disclosures. Both the negative and positive aspects of a company’s operations must be disclosed in the integrated report, together with details of measures to exploit the positive aspects and eliminate or mitigate the negative ones.

On an international scale, the International Integrated Reporting Committee (IIRC) has been established and is seeking international agreement on integrated reporting by companies. It proposes that an annual integrated report, combining financial and non-financial results and future prospects, should become the primary report for companies. The IIRC issued a discussion paper in 2011 and expects to issue formal guidelines in 2013.

In view of the criticisms of current reporting by Cobber and the likely developments in reporting requirements in the future, I would advise the board that it should establish a social and environmental committee to consider these matters further and bring recommendations to the board. This committee could be chaired by the CEO, be comprised of senior management and include a NED among its members.

(Examiner’s note. Detailed comments about the King Report are included in this answer for the sake of completeness. Similarly, the reference to the IIRC consultation process has been included to draw attention to continuing developments in this area of reporting. Candidates taking the examination in November 2012 were not required to include this detail in their answers, although credit was given to any candidates who did.)

Examiner’s comments

This was not a popular question, but the most common weaknesses in answers were as follows.

- In part (a) some candidates explained why companies might be pursuing CSR policies, without explaining why they should report on these policies. The question was about reporting on CSR policies or performance, not the policies themselves.

- Answers to part (c) in general lacked any detail, suggesting that candidates did not know about the requirements for the business review. Some candidates did not answer the second part of question (c), where marks were awarded for a simple and sensible opinion about the adequacy of regulatory reporting/information requirements.
TGB Bank (‘the bank’) is a listed UK company. It has been the subject of speculation in the financial press about its financial position. There are suggestions from some commentators that many of the bank’s financial instruments, including financial derivatives, have not been properly valued in the bank’s financial statements.

The bank’s auditors have also been criticised for going along with the valuations by the bank, and some shareholders have accused the auditors of lack of independence from the board of the bank. They believe that the auditors are ‘bullied’ into accepting the bank’s point of view. This accusation has been strongly denied by both the firm of accountants and the bank’s board, although the firm has been acting as auditor of the bank for many years and also earns considerable fees each year for non-audit engagements.

When the bank published its annual report and accounts several weeks ago, there were complaints that they lacked clarity and were very difficult for non-accountants to understand. There was also intense criticism, as in the previous year, of the high levels of remuneration for many employees of the bank.

In the past few days, fraudulent trading activities by one of the traders on the bank’s derivatives desk has been discovered, and early estimates are that the bank might have lost tens of millions of pounds as a result of the fraud. The fraud has been reported in the press and the trader has been arrested by the police. Some commentators are blaming the board of the bank. Others are suggesting that the blame lies with the auditors. There appears to be a general view amongst the investment community that the bank is failing to uphold the standards of corporate governance that should be expected from it.

The chairman is also aware of a need to review the effectiveness of the board’s risk committee as a matter of some urgency.

Required

As company secretary, prepare a briefing paper for the chairman in which you:

(a) Describe three of the main principles of good corporate governance and suggest whether, and in what ways, the bank may be in breach of these principles. (6 marks)

(b) Explain the importance of ensuring the independence of the bank’s external auditors, identify the possible threats to the independence of the auditors of the bank and recommend measures that might be taken to protect their independence. (9 marks)

(c) Explain the respective responsibilities of the bank’s board and the external auditors for the prevention and detection of fraud in the bank. (4 marks)

(d) Suggest the role and responsibilities of a risk committee of the board in financial institutions such as banks. (6 marks)

(Total: 25 marks)
Suggested answer

Briefing paper

To: The chairman
From: Company Secretary
Date: 29 November 2012

Subject: Governance, auditors and risk

This paper provides information on four issues.

(a) Compliance with principles of corporate governance

The four main principles of corporate governance are fairness, accountability, responsibility and transparency.

Accountability is the principle that decision makers in a company should be accountable for the decisions that they make. The board of directors should be accountable to the shareholders and executive management should be accountable to the board of directors. Responsibility is the principle that the board should accept full responsibility for the powers that it has been given (and that management should be responsible for the authority they have been given). Responsibility and accountability go together.

It is not clear whether TGB Bank is in breach of these principles. Shareholders may criticise the board for failing to carry out its responsibilities sufficiently. The board has not obviously accepted responsibility for any of the problems at the bank, such as its financial position and the fraudulent trading. Shareholders may also argue that the bank’s executives are rewarding themselves with high levels of remuneration without demonstrating clearly what they have done to earn these rewards.

Transparency is the principle that a company should make its aims and achievements clear, and should not try to hide or disguise any matters. Without transparency, there cannot be enough trust between a company and its shareholders. Transparency is provided mainly through open and honest reporting.

Transparency does not mean ‘understandability’ but the bank does not seem to make clear what its financial position is, and there are questions about the honesty of the valuations of its derivatives. Shareholders may therefore have doubts about the financial stability of the bank, and so do not trust its directors.

(b) Independence of the external auditors

An important requirement for good corporate governance is that the board of directors should be accountable to the shareholders. Accountability is achieved through the requirement to produce the annual report and accounts, and through general meetings of the company. It is therefore essential that the information provided in the report and accounts should be reliable, presenting a true and fair view of the company’s performance and financial position, and also about its prospects for remaining as a going concern in the foreseeable future.

The external auditors provide a professional, independent opinion about the truth and fairness of a company’s accounts, and the shareholders rely on this opinion. Although in practice the board appoints the auditors, the formal appointment of the auditors is decided by the shareholders each year at the AGM, and the auditors’ report is made to the shareholders, not the board of the company.

If there are doubts about the independence of the auditors, the reliability of the financial report and accounts will be brought into question.
The need for independence of the auditors is recognised by the accountancy profession, and honesty and objectivity (both related to independence) are ethical principles that all accountants are required to observe.

There are possibly three major threats to the independence of the auditors, giving rise to allegations that the auditors may be ‘bullied’ into accepting the views of the bank’s management:

(i) There may be a familiarity threat. If the auditors have become too familiar with a company and its management, they may be more inclined to believe what management tell them, and they may fail to ask enough questions or to challenge management sufficiently.

(ii) There may also be a self-interest threat. The bank may be a major client of the firm of accountants, and the fee income from audit and non-audit work may be substantial. If so, the accountants may not want to raise questions about the report and accounts if, as a result, they may lose the business of the bank.

(iii) A different threat is the risk that the auditors in the audit team may not have sufficient knowledge and competence about banking to perform the audit to a satisfactory standard. Management may be able to hide information or make false representations because they know more about the business than the auditors.

There are several ways in which the independence of the auditors may be protected:

(i) Independence of the auditors from the bank’s executive management can be protected by giving the audit committee responsibility for reviewing and ensuring auditor independence. The audit committee should approve the terms of the audit engagement, including the audit fee. The auditors should be required to report to the audit committee on matters arising from the audit, as well as reporting to management. The committee should review the annual audit after completion and may recommend a change of auditor if the quality of the audit does not appear satisfactory.

(ii) The audit committee should also have responsibility for the policy of awarding non-audit work to the auditors. This policy should be approved by the board, but its implementation should be monitored by the audit committee. By restricting non-audit work, and fee income from this work, threats to independence may be reduced.

(iii) The company may decide on a policy of changing its audit firm regularly, for example, at least every seven years. If an audit firm knows that it will not retain the audit forever, the auditors are more likely to challenge the opinions of management.

(c) Responsibilities for preventing and detecting fraud

The board of directors of the bank has responsibility for the prevention of fraud and for the detection of fraud when it occurs.

The board delegates to management the responsibility for designing and implementing internal controls for preventing and detecting fraud, but the board is responsible for reviewing the effectiveness of these controls and for reporting to shareholders that they have done so.

If a fraud occurs, the board should be accountable to the shareholders.

The auditors have a responsibility for giving an opinion on whether the financial statements give a true and fair view. They must therefore recognise that fraud could result in serious misstatements in the accounts, unless the fraud is discovered. As a part of the audit, auditors should therefore consider the risk of fraud and should carry out audit checks where risks are identified. They could be held liable for failure to do this.
Even so, the company’s board and managers have responsibility for fraud, not the auditors.

(d) Risk committee

In the UK the Walker Committee recommended, following the global crisis in banking, that the board of banks should establish a risk sub-committee, with special responsibility for advising the board on high level risk matters. Risks in banking, particularly financial risks, are very high and they are also complex.

A risk committee of the board, consisting mainly of non-executive directors suitably trained in risk, but also with the bank’s finance director as a member, should have responsibility for monitoring risk and reporting to the board, and giving advice on high-level risk matters. The committee may be advised by the bank’s senior risk officer.

The ICSA has issued guidance on the terms of reference for a risk committee in institutions such as banks, and suggested responsibilities include the following:

(i) To advise the board on risk appetite, risk tolerance and future risk strategy.
(ii) To report to the board on current risk exposures.
(iii) To monitor the bank’s risk assessment procedures and review the effectiveness of its internal control and risk management systems, including procedures for detecting fraud.
(iv) To report to the board on its meetings and to shareholders (in the annual report) on its activities and the bank’s risk management and strategy.

Responsibility for the operational aspects of risk management should remain with executive management, and the board risk committee should not interfere in the detailed day-to-day aspects of risk management.

(Examiner’s note. Detailed comments about the risk committee are included in this answer for the sake of completeness. Candidates taking the exam in November 2012 were not required to include this detail in their answers, although credit was given to any candidates who did.)

Examiner’s comments

Part (a) On the whole this question was answered well. Many candidates identified the main principles of corporate governance and related these to the details in the question scenario. However, some candidates did not attempt to relate the principles to the scenario and so did not identify breaches in the principles and did not therefore answer the question in full. Other candidates listed the main principles of corporate governance but did not explain correctly what they mean. Some candidates also appeared unaware of the main principles of corporate governance.

Part (b) The main problem with answers to this part of the question was a lack of explanation. Many candidates appeared to assume that more obvious points did not need to be explained, for example, some answers listed threats to auditor independence (such as self-interest threats and familiarity threats) without explaining why these were threats, and included threats that simply should not occur in practice (such as advocacy threats and self-review threats). These answers also suggested measures to reduce the threats without explaining how each measure might reduce the threat.

Part (c) This question part was largely well answered.

Part (d) In contrast part (d) was, in general, not answered well, with many answers not demonstrating an awareness of the role of a risk committee of the board. A few answers referred to the risk committee of the board as a risk management committee. However, a risk management committee in a bank is a committee of executives and risk officers, and is not a board committee.
5. Feast Limited (‘Feast’) is a very successful private company and its recent growth has been rapid. The board of the company is now planning to change the company status to a public limited company (plc) and obtain a full listing and admission of its shares for trading on the stock market, to coincide with the planned takeover of another company in the same industry.

The board of Feast has invited Nicola Bevan (‘Nicola’), the Finance Director of another company, to join the board as a non-executive director. Nicola has been Finance Director of her company for less than a year, and does not yet hold any non-executive positions. Her only previous experience of corporate governance was in her previous position as Finance Director of a medium-sized private (unquoted) company.

Nicola was surprised to receive the invitation from the board of Feast, and had been expecting that she would have to develop her experience further before receiving the offer of non-executive directorships from other companies. She is not sure how to respond. Before deciding whether to accept the offer, she would like more information about corporate governance and she would also like to carry out due diligence on Feast and consider the proposal from the perspective of her future career development.

Required

(a) Explain the main differences between corporate governance practice in a medium-sized unquoted company and in a UK listed company.

(10 marks)

Suggested answer

UK listed companies are required by the Listing Rules to comply with the provisions of the UK Corporate Governance Code (‘the UK Code’), or to explain their non-compliance. Consequently, UK listed companies comply with most or all the provisions of the UK Code. Guidance and principles of corporate governance for unquoted companies have been issued by the Institute of Directors, but these are voluntary.

Unquoted companies with plans to obtain a listing for their shares should be expected to develop their corporate governance structures so that they will conform to the provisions of the UK Code when they eventually seek a listing.

Differences in corporate governance between a listed company and a medium-sized unquoted company include the following:

(i) Governance standards are higher for public companies because of the separation of ownership from control (management), the greater risk for investors and the need to assure investors. Without such assurance a listed company will have difficulty in obtaining access to public capital and liquidity in the market.

(ii) A listed company is likely to have a larger board of directors, with at least two independent NEDs. The chairman will usually be independent on appointment. In an unquoted company, the NEDs may not be independent, and the chairman is unlikely to be independent (and may even have some executive responsibilities).

(iii) The UK Code states that the roles of chairman and CEO should not be held by the same individual. In medium-sized unquoted companies, the same individual may well hold both positions, especially when share ownership is concentrated in the hands of a family.

(iv) Listed companies are subject to much more extensive disclosure requirements. They are required to provide disclosures about the remuneration of directors (as a requirement of the Companies Act 2006) whereas unquoted companies do not. Quoted companies are
also subject to more extensive disclosure requirements about significant risks and social and environmental issues.

(v) The financial statements of listed companies will also provide more extensive financial information. Small and medium-sized companies in the UK are able to report in accordance with the (more restricted) accounting standard for SMEs.

(vi) The internal control and risk management systems in medium-sized unquoted companies will be less extensive than in larger listed companies. An unquoted company may not have an audit committee.

(vii) The governance arrangements at board level will be much less formal in an unquoted company than in a listed company. Medium-sized unquoted companies are unlikely to have a nomination committee or remuneration committee. Although there are benefits in having a company secretary medium-sized companies are not required to have one, unlike listed companies.

(viii) There will also be much less formality in a medium-sized unquoted company in matters such as re-election of directors, social and environmental policy and reviewing the performance of board directors.

Progress from unquoted company to listed company involves changes in the corporate governance framework. In the case of Feast, its progress from unquoted company to planning for a full listing has been so rapid that its corporate governance structures may need substantial change and strengthening within a very short space of time.

(b) **Recommend the matters that Nicola should consider and investigate when carrying out due diligence on Feast. Suggest the other matters that Nicola should consider before deciding whether to accept the offer of a non-executive directorship from the Feast board.**

**Suggested answer**

If Nicola intends to accept the NED position with Feast, she must be satisfied that the company is sound, with a strong reputation, and that she will not exposing herself to personal liability or disrepute by joining its board.

She should learn as much as she can about the business of Feast, and its standing in its markets and reputation, in order to satisfy herself that she would like to join the board of the company. If Feast has a poor reputation with investors or the public, her own reputation may be damaged by joining the board.

She must satisfy herself that Feast is in a satisfactory financial position, and can do this with the financial statements, together with any other information that the board of Feast are willing to provide her in confidence. Although she has financial expertise, she is unlikely to want to take on a role in a company that is already in financial difficulties and in need of a lot of her time. She should want to be satisfied that the planned IPO by the company will be successful.

She should find out more about the other members of the board of Feast, and satisfy herself that these are individuals that she will be pleased to have as colleagues.

She should find out whether the company complies with all the provisions of the UK Code and, if not, should consider the nature of, and reasons for, non-compliance. She may wish to ask whether the company has a formal ethics code (and how this is enforced) and whether the company has formal policies and objectives on social and environmental matters.
Nicola should ask about the provision of directors’ and officers’ liability insurance by the company and satisfy herself that this is sufficient and appropriate.

**Expected role**

Nicola should also establish what her role as non-executive director in Feast will be. She is the finance director of her company; therefore it seems probable that the board of Feast will want her to be a member of the audit committee, and possibly the committee chairman. She should also find out how much time she would be expected to commit to Feast each month or year.

She should ask about induction and training, and what the board of Feast will do to help her to learn about the company and become an effective board member as quickly as possible.

She should check the facilities that Feast will provide her with for working during her time at its premises. For example, will she be given an office and desk, a link to the company’s intranet and the services of a PA.

**Personal considerations**

Nicola should consider the fee that is being offered for her services as NED, and whether her employer will allow her to retain the fee. This may affect her decision about accepting the appointment.

She should also be satisfied that she will have sufficient time to do the work, given the demands of her role as finance director for her employer. If Feast holds any of its board meetings in other countries, this could make it more difficult for Nicola to commit the amount of time required.

She should confirm that the appointment will be for a term of three years.

She should satisfy herself that she meets the criteria for independence, and that she has no links with Feast that might threaten or raise doubts about her independence.

Nicola has only recently been appointed as finance director of a listed company, and she may consider that it is too early to take on a NED position with Feast. She may also think that other offers of board appointments may come from other companies that may be more interesting and helpful for her personal career development.

In summary, Nicola needs to be satisfied, from a business, professional and personal perspective, that she would like to become a NED on the Feast board.

**Examiner’s comments**

**Part (a)** Many candidates did not appear to know how to answer this question, although a similar question has featured in the exam in the past. Comments were often limited to the point that listed companies are expected to comply with the UK Code (or explain non-compliance) and comply with other regulations such as the DTR – whereas private companies are not. Some candidates commented that shares of listed companies are traded on a stock market but shares in an unquoted company are not, and it is difficult to see how this fact on its own is a difference in governance between the two types of company. Considering the dominance of the UK Code within the syllabus, candidates were expected to think more broadly of differences, and in much more detail, than was included in most answers.

A few answers assumed that a medium-sized unquoted company means a small listed company, which is not correct. Answers based on this assumption were entirely off the point. Similarly, a number of candidates assumed that medium-sized companies are family-run companies. Some may be, but others are not. An error in the basic understanding of what a medium-sized company is had a significant and adverse effect on some answers provided.
Part (b) As indicated in the general comments, many candidates presented their answers to this question as a list of brief bullet points, with no explanation of why each point was relevant to the question. Answers need to explain points fully in order to achieve marks and should not be brief and assume that the marker knows the points being made.

Some suggestions included in answers about what matters should be considered and investigated were impractical or were not realistic. For example, a suggestion that Nicola should obtain copies of the company’s report and accounts from Companies House overlooked the fact that if the company wanted her as a NED, they should be willing to provide this sort of information directly. In addition, impractical suggestions included recommendations that Nicola should investigate the risk management systems and internal controls of the company, or that she should investigate the effectiveness of the board and its decision-making. This may seem excellent in theory, but answers should have considered how she would be able set about this task in practice.
6. There have been some complaints from shareholders about the remuneration of the senior executive at Bagful plc (‘Bagful’), a UK listed company. The chief executive officer (CEO) for the past ten years has just agreed to retire and as part of his leaving agreement, he will be allowed to exercise his share options for up to five more years after he has retired. He will also be given a consultancy contract with the company for two years, for which the annual fee will be equal to 90% of his basic annual salary at retirement. This agreement was reached with the involvement of the company chairman, who will also soon be leaving the company, although it was formally approved by the remuneration committee.

A replacement as CEO has been identified, but the remuneration committee is still negotiating with him about the details of his remuneration. He would like to be entitled to grants of shares as a long-term incentive arrangement, but at the moment Bagful only has share option schemes in place. He is also arguing for a higher basic salary and better pension entitlements. The remuneration committee has said that it will consider a higher basic salary on condition that performance-related incentives are reduced. The chairman of the remuneration committee is aware of shareholder concerns about the level of executive remuneration in the company, and has commented that shareholders like to complain but do not offer constructive suggestions. However, he is concerned that if the remuneration committee makes unreasonable concessions to the incoming CEO, the shareholders will take some form of action.

He has asked for your advice, as company secretary.

Required

(a) Describe the composition and functions of a remuneration committee in a large listed company, as set out in the UK Corporate Governance Code. Suggest what measures the remuneration committee of Bagful should take to carry out its responsibilities effectively in its negotiations with the incoming CEO.

(12 marks)

Suggested answer

The UK Corporate Governance Code (‘the UK Code’) states that companies in the FTSE 350 should have a remuneration committee of at least three independent non-executive directors. The chairman of the company, if he was considered independent on first appointment, may be a member of the committee but not its chairman.

The UK Code states that the committee should have delegated responsibility for setting the remuneration for executive directors and the company chairman, including pension rights and compensation payments. The committee should also recommend and monitor the level and structure of remuneration of the company secretary and senior management below board level.

The remuneration committee should normally be expected to comply with the principles and provisions of the UK Code, in order to carry out its responsibilities effectively. Bagful’s remuneration committee is negotiating with the incoming CEO on the size of the basic salary and pension entitlements, and its reluctance to agree to the individual’s demands indicates that the committee is aware of its responsibility to ensure that the level of remuneration should be sufficient to attract and retain an individual of the required quality, but that it should avoid paying too much.

The incoming CEO is also demanding grants of shares rather than share options. The committee needs to be aware of the requirement that any new long-term incentive scheme must be approved by the shareholders. In view of the concerns of shareholders about remuneration levels, it may be difficult to win shareholder approval for a new share grant scheme. The committee chairman appears to be aware of this fact, although he is frustrated by the lack of constructive suggestions from shareholders. Remuneration consultants can be engaged to
benchmark remuneration generally, advise on different types of incentive scheme and the current views and voting practices of shareholders on these schemes.

The UK Code states that a significant proportion of the remuneration of executive directors should be related to performance. The remuneration committee has indicated its willingness to agree to a higher basic salary for the CEO but only if the performance-related element in the remuneration package is reduced. The committee needs to consider the UK Code principles before agreeing to this arrangement.

The UK Code states that the remuneration committee should consider arrangements for payments in the event of termination of the employment contract (avoiding paying too much for ‘failure’). Termination arrangements should therefore be included in the negotiated settlement.

The remuneration committee will need to approve its statement to shareholders for inclusion in the annual report. This could include a personal statement from the chairman on the deliberations and performance of the committee during the year. He will also be expected to answer questions from shareholders at the AGM and may well want to engage with investor representative bodies prior to the meeting.

(b) Explain why, in this scenario, it is not acceptable practice for the chairman to be involved in negotiating the leaving terms for the outgoing CEO.

Suggested answer

The leaving terms for the retiring CEO, to the extent that they are not provided for in his remuneration agreement, should be negotiated by the remuneration committee. If the company chairman was a member of the committee, he should have been involved in the negotiation to some extent, although the negotiations should have been led from the company’s side by the chairman of the remuneration committee, not the company chairman.

A remuneration committee should be expected to consult with other members of the board, particularly the chairman or CEO, on remuneration issues, because they may be able to offer valuable advice. This means that even if the outgoing chairman was not a member of the remuneration committee, it would have been appropriate for the committee to ask for his views.

It is not clear exactly how much involvement the chairman had in the negotiations on the settlement with the CEO, which may seem over-generous to the shareholders. In view of the fact that the chairman would soon be retiring himself, it would have been inappropriate for him to be involved in the detailed negotiations. This is because his continued commitment to the company might be questionable, and having left the company he would not be accountable to the shareholders for the benefits that the outgoing CEO received.

Leaving arrangements will be included in the annual report and may affect the shareholders’ vote for the remuneration report or their support for the directors who chair or sit on the committee. The chair of the remuneration committee should therefore include these matters in the discussions with shareholders prior to the AGM.

(c) Explain the various rights and powers of shareholders of Bagful to block or amend the remuneration arrangements for senior executives in the company.

Suggested answer

Shareholders do not have a right to approve or veto the remuneration package negotiated with any senior executive by the company. However, major shareholders may be able to influence decisions by the company by making their views on remuneration policy clear to the board.
Shareholder approval is required when the company wishes to introduce a new long-term incentive scheme, or amend an existing scheme (a share option scheme or share grant scheme). However, this voting right applies to the scheme as a whole and not to the entitlements that individual executives or employees will receive within the operation of the scheme.

The UK Code includes a requirement that all directors in FTSE 350 companies should stand for re-election each year. This means that the shareholders could vote against the re-election of any member of the remuneration committee or any over-paid executive director. However, they would need a majority of the votes in a vote against re-election and the company may suffer if a key executive director is not re-elected.

In the UK there is also a legal requirement for shareholders to vote on the remuneration report at the AGM. They can show their disapproval of the company's remuneration policies by voting against the report, but the vote is advisory only, and shareholders have no power to alter the terms of the remuneration package of any director.

Since shareholders have limited rights and powers over remuneration arrangements by the company, they may rely on persuasion and on pressure from investment organisations. Pressure may also be applied by shareholders by means of using the media to publicise their concerns about the remuneration of particular directors, and using public concern as an indirect form of influence.

The influence of shareholders over a particular issue may be increased through collective action, which is suggested by the UK Stewardship Code as a way of escalating action.

Examiner's comments

On the whole this question was answered well, with the exception in part (a) that:

- Many answers did not state correctly the provisions about the composition of a remuneration committee.
- Many answers did not address the specific issues raised in the question with regard to the demands of the incoming CEO.

Also, many answers to part (a) included the suggestion that if shareholders were dissatisfied with remuneration of senior executives at the company, they might be able to requisition an extraordinary general meeting to discuss the problem. Students of company secretaryship should be aware that general meetings are called to consider and vote on propositions or proposals and a meeting to discuss a problem need not be a formal general meeting. Answers including this suggestion tended to display a lack of understanding of shareholder rights in general.

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.