

Suggested answers and examiner's comments

Corporate Governance

June 2016

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 general standard of answers in June 2016 was not high, with the overall pass rate, at 47%, being only marginally higher than in November 2015.

Answers which did not achieve a pass standard covered the general principles and provisions of corporate governance, but did not apply these to practical situations or adequately discuss, analyse or evaluate the issues. In addition, relevant instructions were often not taken from the command words within the questions.

Many candidates applied their answers to the given scenario when this was not required of a certain part of a question. This resulted in a narrow scope to the answer and low marks being awarded.

As in previous papers, candidates did not use the mark allocation for each part of a question in providing them with a guide as to the detail required in an answer. The required level of detail for an 8 mark question is lower than for a question carrying 13 marks or more. For higher mark questions to be answered well, a greater depth of knowledge will be required on the topic which will also usually need to be applied to a given scenario or analysed as a governance concept (for example). The setting out of relevant governance principles alone will not be sufficient to gain a pass for such questions.

Candidates also did not consider who the intended reader is (for example, the board or the chairman) and write their answers in an appropriate style. In addition, understanding the actual question being asked is of great importance and provides the focus required in an answer. Too often answers only provided general information in respect of a subject, for which marks cannot often be awarded.

Many answers demonstrated a lack of understanding of the UK Corporate Governance Code, with few references being provided and a lack of detailed comprehension of the fundamental governance concepts. The UK Corporate Governance Code has a relatively short length and is also reproduced in full within the Corporate Governance study text. As the study text states, a good knowledge of the principles and provisions of the UK Corporate Governance Code will be required, together with supporting guidance published from time to time.

- 1 The board of Bryant plc ('Bryant') has recently grown in size and the Chairman, Louise Abbott, is considering how to enhance its effectiveness, particularly in terms of decision-making. Bryant operates in a highly technical field, so board decisions can be delayed due to a significant volume of questions being raised at its meetings. These questions have to be referred to the relevant technical team within Bryant or to external advisors who have assisted in the research and development of the technology. Many of the directors have also highlighted that the volume and complexity of the board papers is an issue and that there is insufficient time to fully digest the information prior to meetings.

Louise would like to be advised on addressing these issues and how she, as Chairman, and you, as Company Secretary, can contribute directly to improving the effectiveness of the board.

Required

- (a) Discuss the factors that can affect decision-making and board effectiveness.

(12 marks)

Suggested answer

Decision-making is an important board activity. There should be a clear policy about what matters require a board decision or approval and relevant processes established. As stated in the UK Corporate Governance Code (UK Code), there should be a formal schedule of matters reserved for the board.

Good decision-making can be improved by providing directors with sufficient time to prepare for meetings and allowing sufficient time for discussions at the meetings.

The FRC Guidance on Board Effectiveness suggests that good decision-making can be facilitated by high quality documentation being provided to the board and, where appropriate, obtaining the views of an expert. In addition, time should be allowed for debate and challenge in respect of proposals being considered with a view to reaching a decision in a timely manner. The board should ensure that it clearly communicates the actions required to implement a decision, the timescales that apply and who is responsible for carrying these out.

The FRC Guidance also cites a number of factors that can limit the quality and effectiveness of decision-making. These include: a dominant personality or group within the board; insufficient attention being given to risk; executive directors not involving non-executive directors (NEDs) in certain matters; a weak organisational culture or ethical standards; complacent and/or intransigent attitudes; emotional attachments; conflicts of interest; and inadequate information being provided about an issue or analysis.

- (b) Explain how Bryant and its board can overcome the issues it is experiencing, discussing the specific contributions that you and Louise can make to this process of improvement.

(13 marks)

Suggested answer

From the scenario, there are three main areas which need to be addressed.

Firstly, the format and length of the documentation circulated to the board needs to be reviewed. Papers for the board could include an executive summary, which sets out the key elements of the proposal and clearly states the decision which is sought from the board. More detailed information could then support this summary. Graphical representation of technical or statistical information may also assist in understanding. As Company Secretary, I could introduce a set of guidelines for the required format and standard of board papers.

Secondly, papers for the board also need to be distributed much earlier to allow sufficient preparation time. As Company Secretary, I could review the timetable for paper submission and

circulation to address this. In addition, it could certainly be worth considering the use of electronic means for the distribution of board papers if these are not currently used (for example: by email, into a shared access facility or through a board portal package such as BoardPad).

Thirdly, the technical nature of the industry in which Bryant operates makes the papers difficult to understand. The board could invite a member of the relevant technical team, or external advisor, to attend a meeting and present to the board. An initial presentation could perhaps be made in advance of a proposal being formally considered by the board. In this way, the board would be provided with an overview of the proposal before receiving the more detailed paper for consideration. Likewise, a relevant expert could be asked to be available on the day of the board meeting should they be required to answer any questions.

Alternatively, for certain projects and proposals, it may be helpful for a temporary sole-purpose committee of the board to be established to consider the matter in more detail. Technical teams and experts could then be involved in these discussions and the committee can then present their recommendation to the board.

In terms of chairing, a board needs to be led by a Chairman who can control a meeting without dominating it. An effective Chairman should ensure that all board members participate in discussions and that there is the opportunity for challenge and debate. Indeed, the FRC Guidance suggests that, where appropriate, the Chairman should actually introduce a challenge into a discussion in order to test proposals thoroughly. It can also be useful for a Chairman to summarise the discussions held and decisions made throughout a meeting to verify the directors' understanding.

Examiner's comments

Question 1 was one of the more popular questions, but the majority of candidates who attempted it did not answer it well, with the overall pass rate for the question being the lowest of the paper.

Many candidates answered Question 1(a) in relation to the company given in the scenario (Bryant), rather than in general terms as the question required. Answering part (a) in relation to the scenario greatly limited the scope of answers, which contributed to the low pass rate.

For Question 1(b) candidates recognised the issues being experienced by Bryant, but suggestions on dealing with these were often very general in nature.

Most answers focused, to some degree, on the issues on board papers and the complexity of matters under consideration as detailed in the scenario. However, many candidates discussed board composition in detail with little reference to how board paper preparation and content could be improved. Marks were awarded where board composition points were made, but candidates were required to discuss the issues in the scenario in order to gain a pass.

Very few candidates turned their attention to Louise Abbot, as Chairman, and how she could specifically contribute to the improvement process. In addition, suggestions on improving the board paper process did not particularly tackle the complexity issue or consider suggestions on how the candidate, as Company Secretary in the scenario, could assist with improvements.

- 2 Westhill plc ('Westhill') has recently undertaken a board effectiveness review and, as a result, the CEO, Henry Bishop, is questioning the effectiveness of the non-executive directors (NEDs). The current board has been long-standing and the company's activities and its industry have changed and developed quite significantly over recent years. Henry is concerned that many of the NEDs do not have specific industry experience and may not understand the full scope of the company's current operations.

One of the NEDs is also due to retire and a new NED will be joining the board shortly.

Henry has approached you, as Company Secretary, for assistance.

Required

- (a) Analyse the criticisms which are made regarding the effectiveness of NEDs.

(8 marks)

Suggested answer

There are differing views about the effectiveness of NEDs. The accepted view is that NEDs bring experience and judgement to the board's deliberations that the executive directors on their own would lack. An alternative view is that the effectiveness of NEDs can be undermined by:

- a lack of knowledge about the business operations of the company;
- insufficient time spent with the company;
- the weight of opinion of the executive directors on the board; and
- delays in decision-making.

A number of criticisms have been made in respect of NEDs and their effectiveness, including the way NED appointments are made and the number of NED positions some individuals hold, which can certainly be more than they could possibly serve effectively. It is often seen that NED roles are given to the executive directors of other listed companies, giving rise to concerns about a "favoritism" culture existing.

Boards of directors of public companies have been accused of failing to stand up for shareholders' rights against over-powerful executives. NEDs have also been condemned as the "missing link" in the chain of good corporate governance.

NEDs should help to make the board more accountable to the shareholders. However, shareholders have the opportunity to discuss the company's affairs with the NEDs in a formal setting, at general meetings of the company only. Any other discussions between shareholders and NEDs must be informal, if they take place at all.

The law (Companies Act 2006) makes no distinction between executive directors and NEDs. In principle, NEDs can be equally liable with the executive directors for negligence and failure of duty. Arguably, this threat of criminal or civil liability can make NEDs more likely to support their executive director colleagues.

Faith in NEDs to bring sound corporate governance practice to public companies can therefore be misplaced. It has been suggested that NEDs cannot hope to govern a company better than the executive directors, because they cannot know as much about the company as the full-time executives do (Lord Young speech, 2002).

- (b) Discuss how Westhill can maximise the effectiveness of its NEDs, particularly in view of Henry's concerns.

(9 marks)

Suggested answer

In order to maximise the effectiveness of NEDs the following approaches could be taken by Westhill:

- Ensure that the board as a whole is supplied in a timely manner with information in a form and quality appropriate to enable it to discharge its duties (as stated within the UK Corporate Governance Code 2014).
- Provide a thorough induction programme for NEDs which is regularly updated. This is a particularly relevant point given Henry Bishop's concerns around the NEDs' lack of industry experience and the possibility that they may not fully appreciate the scope of the company's current operations. In addition, given that a new NED will be joining the board shortly, there is certainly an immediate need for the company to establish an effective induction programme.
- Provide opportunities for the NEDs to make visits to the company's operational sites, be updated on the operations of the company and developments within the industry. Again, this is a particularly relevant suggestion which would provide Westhill's NEDs with direct access and insight to the company's operations.
- Offer training opportunities (for example, internal and external updates, seminars and conferences), specific to the company and/or industry and in terms of other more general skills as may be required, which can often be identified following a performance review of the NEDs.
- Set out the expected time commitment within the NEDs letter of appointment and monitor other non-executive and executive roles held in other companies and organisations.
- Seek to appoint a strong Senior Independent Director to ensure that the opinions of the NEDs are properly considered and there is no overriding influence from the executive directors.
- Whilst major decisions should be reserved for the board and could therefore be delayed due to the time required to convene and hold a meeting and to provide sufficient time for consideration of papers circulated beforehand, it could be argued that such decisions should be given full and careful consideration. In addition, NEDs having a range of skills and experience often distinct from that of the executive directors, can contribute positively to this decision-making process.

- (c) Advise on the type and range of enquiries that an individual should make when considering an appointment as a NED.

(8 marks)

Suggested answer

The ICSA's guidance note on "Joining the right board: due diligence for prospective directors" sets out those areas a prospective NED should consider. The company's annual report and website should be reviewed in order to obtain information concerning the company's business model and governance; the market environment; recent operational performance; the company's strategy and the main risks it faces; sustainability issues and policies; and financial performance. Media and regulatory announcements issued since the last annual report should be reviewed. Meetings with the CEO, CFO and company secretary and all members of the board (or at least the nomination committee) should be arranged. Where an NED is a member of the audit committee, then a meeting should be arranged with the company's internal and external auditors.

An individual considering an appointment as a NED should be satisfied that they can commit to the role in terms of time; can make a positive contribution to the board (particularly where company performance needs improvement); are not aware of any risks that the directors could be held liable for any breach of duty; there is sufficient and relevant D&O liability insurance to protect against risks; the fee being offered by the company is adequate; there will be a suitable induction programme; and there will be sufficient support from the company secretary and secretariat.

An individual should seriously question acceptance of an appointment in circumstances where a company uses unethical business practices, has a bad reputation, or is in serious financial difficulties.

Examiner's comments

Question 2 was the most popular question but it was not on the whole answered well, with the overall pass rate for the question being one of the lowest of the paper.

Many candidates answered Question 2(a) in relation to the company given in the scenario (Westhill), which seriously limited the scope of their answers. The result of this approach was to limit the criticisms of NEDs to three or four points made in the scenario, rather than analyse those generally made (around eight to ten, as detailed in the suggested answer above).

Many candidates discussed refreshing the board in Question 2(b), at the expense of other relevant material in respect of ensuring the effectiveness of NEDs. Marks were awarded where board refreshment points were made, but candidates were required to discuss how the effectiveness of NEDs can be maximised in order to gain a pass.

In Question 2(c) some candidates answered in terms of the enquiries, or considerations, a company would need to make in respect of the appointment of a NED. Marks were awarded for relevant suggestions which could cross-refer to the enquiries an individual should make, but again this approach limited the scope of answers. No references were made to the ICSA guidance note "Joining the right board: due diligence for prospective directors". Awareness of this guidance note would have greatly assisted candidates in providing a relevant and comprehensive answer.

- 3 You act as a company secretarial consultant. Edward Bruce, the CEO of Diagon Retail Ltd ('Diagon'), has informed you that the company is considering an initial public offering (IPO). Edward and his board have asked you to provide them with an overview of corporate governance, with an emphasis on the company having high standards of ethical behaviour. Edward has come across references to the "overarching corporate governance principles" as set out in the original King Code. He seeks further explanation of these principles and guidance on adopting a formal code of ethics within Diagon.

In addition, Edward is concerned about the use of a new overseas supplier which has been proposed to source a clothing range more cost-effectively.

Required

Prepare a report to the board of Diagon in which you:

- (a) Explain what the overarching corporate governance principles described within the original King Code are.

(8 marks)

Suggested answer

Diagon Retail Ltd
Board Report – Ethics and corporate governance
Prepared by: Company Secretarial Consultant
Date: June 2016

King Code principles

Several concepts apply to sound corporate governance in all countries where international investors invest their money. Many of these are ethical in nature and the original King Code described them as the "overarching corporate governance principles".

Fairness – a concept linked to ethical behaviour and integrity. There should always be fairness in the treatment of minority shareholders when there is a majority/dominant shareholder. Other stakeholders should also be treated in a fair and ethical way. Companies should act in an ethical manner as this underpins good corporate governance.

Accountability – decision-makers who act on behalf of a company should be accountable for the decisions they make and the actions they take. The board of directors should be accountable to the shareholders, the company's owners. Shareholders should be able to assess the actions of the board (and its committees) and have the opportunity to query and challenge them. Management should be accountable to the board of directors for the way in which they have exercised their responsibilities.

Responsibility – the board of directors is given authority to act on behalf of the company and a further principle of corporate governance is that it should accept full responsibility for the powers that it is given and the authority that it exercises. A board of directors should understand what its responsibilities are, and should carry them out to the best of its abilities. The board of directors should be accountable to the shareholders and other stakeholders.

Accountability and responsibility go hand in hand.

Transparency – this means openness and a willingness by the company to provide clear information to shareholders and other stakeholders about what the company has done and hopes to achieve, without giving away any commercially sensitive information. Reporting is an important element of governance. Shareholders and other stakeholders have a right to be told.

- (b) Distinguish between the different models of corporate ethics and discuss the reasons why Diagon might develop a formal code of ethics.

(11 marks)

Suggested answer

Models of corporate ethics and a formal code

There is a connection between corporate ethics and the different approaches to corporate governance. If a company has a shareholder approach to corporate governance it puts the interests of shareholders ahead of the interests of anyone else. If a company adopts a stakeholder approach to governance, it will act in a way that takes into consideration the needs and concerns of other stakeholders.

There are no specific rules about what a code of corporate ethics should contain. The Institute of Business Ethics (IBE) identifies two styles of ethical code – a stakeholder model code and an issues model code.

In the stakeholder model there should be codes of behaviour for each specific stakeholder group, including: employees; customers; shareholders and other providers of money; suppliers; society or the wider community.

An issues approach focuses on specific issues relating to ethical or unethical behaviour. An issues model of ethical code may contain elements including: compliance with laws and regulations (perhaps in all countries where a company operates); prohibition of bribery which may go so far as restrictions on gifts and corporate hospitality; timely payment of suppliers; environmental responsibilities; methods of competition (avoiding industrial/computer espionage); avoiding conflicts of interest; the use of company assets by employees; safeguarding personal data held on customers; rules on political donations; and application of human rights, including those of suppliers.

It is suggested that there are three reasons why a company might develop a formal code of ethics:

- (i) Compliance and customer service – the company wants to ensure that all its employees comply with relevant laws and regulations and conduct themselves in a way that the public expects.
- (ii) Managing stakeholder relations – a code of ethics can help to improve and develop the relations between a company and its shareholders and other stakeholders, by improving the trust that they have in the company.
- (iii) Creating a value-based organisation – it may be argued that an ethical company, like a well-governed company, is more likely to be successful in business in the long term.

As Diagon is considering an IPO it can expect greater scrutiny of its ethical behaviour and could, therefore, benefit from developing its own formal code.

Additionally, the conditions of workers within overseas suppliers have proven to be controversial for a number of companies in recent times and, therefore, it may be timely for Diagon to develop a formal code of ethics which includes guidance on this and other ethical issues.

- (c) Analyse the ethical issues that using a new supplier could raise and how these might be effectively managed and controlled at Diagon.

(6 marks)

Suggested answer

Ethical issues relating to the use of a new supplier

The main ethical issues which would need to be considered in using a new supplier would be focused in four main areas: staff; premises; sustainability and environmental impact.

Investigations into the wages, working conditions and treatment of staff should be made, including that there is no use of child labour and no discrimination.

The suitability and condition of the factory or other business premises should be checked (an issue highlighted by the events in 2013 at a clothing factory in Bangladesh).

The sustainability of the source or raw materials being used should be considered to ensure that supplies are not being diminished or devastated. The decision to contract with a new supplier must be justified from a sustainability viewpoint and not be concerned with short-term gains (for example, in relation to immediate cost savings that are obtainable). In addition, the choice of one supplier over a number of potential suppliers would need to be qualified in terms of meeting the company's objectives and contributing to its future success.

In terms of environmental impact, issues concerning the health and safety standards and incidents record at the supplier's factory, emissions from its operations and other factors (its location and impact on the community) should be considered. In addition, reviewing the methods of distribution used and how these impact on traffic, vehicle and other emissions and transport routes would be useful indicators of the potential environmental impact of the supplier.

Examiner's comments

Question 3 was the least popular question, but those candidates who attempted it answered it well.

Credit was available for providing a suitable heading/introduction/format for a report to the board, but many candidates' answers lacked this formality.

Answers which met a pass level for Question 3(a) demonstrated a very good understanding of the principles of the King Code. Some candidates, however, appeared unfamiliar with the King Code, although many were still able to gain marks by providing details of the relevant general concepts of corporate governance.

Pass-standard answers to Question 3(b) demonstrated a very good understanding of the models of corporate ethics and discussed the reasons for developing a formal code. There were some candidates who did not appear to be familiar with, or able to explain the relevant models or the benefits to Diagon (in the scenario), of having a formal code of ethics.

Lower marks in general were gained for Question 3(c) where, although most candidates identified the issues in using a new supplier, many did not adequately address the practicalities of how the company in the given scenario (Diagon) could effectively manage and control them. This part of the question illustrates the difficulty candidates often have in taking a practical approach to a question and applying relevant governance concepts.

- 4 Higgins plc ('Higgins') is preparing for its flotation on the London Stock Exchange and, at present, is concentrating on audit procedures. It needs to establish an audit committee, and also address some issues with regard to its external auditors. The current auditors, Stock LLP, are willing to continue their appointment but concerns have been raised by the board in respect of Stock LLP's independence, due to the amount of non-audit work they have carried out for Higgins in the past. The Chairman of Higgins is of the opinion that new auditors should be appointed and that the appointment should be put out to tender. The CEO disagrees and would like Stock LLP to remain, in order to provide continuity. The board has requested that you, as Company Secretary, prepare a paper for its consideration.

Required

Prepare a paper for the board of Higgins in which you:

- (a) Explain the requirements for the composition of an audit committee, and its role and responsibilities, as required by the UK Corporate Governance Code 2014.

(15 marks)

Suggested answer

Composition of audit committees

The UK Corporate Governance Code 2014 (UK Code) states that an audit committee should consist of at least three members (or at least two in the case of small companies, outside the FTSE 350). All members of the audit committee should be independent NEDs.

The company chairman should not be a member of the committee, unless the company is outside the FTSE 350, in which case the chairman may be a member (but may not chair the committee) provided that he was considered independent on appointment as chairman.

The board should also satisfy itself that at least one member of the committee has recent and relevant financial experience (so, for example, should ideally have a professional qualification from one of the accountancy bodies).

The company secretary should act as secretary to the committee.

Role and responsibilities

The UK Code states that the role and responsibilities of an audit committee, excluding those concerned with risk management and internal controls, are to:

- Monitor the integrity of the company's financial statements and any formal announcements relating to financial performance.
- Make recommendations to the board in relation to the appointment, reappointment or removal of the external auditors, to put to the shareholders for approval in a general meeting of the company.
- Approve the remuneration and terms of engagement of the external auditors.
- Review and monitor the independence of the external auditors and the objectivity and effectiveness of the audit process, taking into account relevant UK professional and regulatory requirements.
- Develop and implement the company's policy on using the external auditors to provide non-audit services, taking into account any external ethical guidance on the subject.
- Report to the board on how it has discharged its responsibilities.

- (b) Advise how Higgins should deal with the issues raised in respect of the current auditors. (10 marks)

Suggested answer

Advice to Higgins

In respect of Higgins, the main issue with auditors undertaking non-audit work is that when the firm audits transactions which have been recommended by its consultancy arm, it is unlikely to take an independent view. This creates a serious threat to an auditor's independence and objectivity and examples of this have been seen in cases such as Enron (2001) and Vodafone (2002).

The UK Code states that the annual report should contain an explanation as to how, if an auditor provides non-audit work, auditor objectivity and independence is safeguarded. The King III Code states that an audit committee must define a policy for non-audit services provided by the external auditor and must approve the contracts for non-audit services.

The FRC guidance on audit committees includes guidance on auditor independence, including the provision of non-audit services by external auditors. It states that the objective of the audit committee should be to ensure that the provision of non-audit services by the company's audit firm would not impair the objectivity and independence of the auditors.

Another approach for protecting audit independence is for there to be a rotation of the audit firm (at least every ten years for FTSE 350 companies) and, particularly where the same audit firm remains in place for some time, of the audit partner (at least every 5-7 years).

In summary, Higgins should look to review the independence and objectivity of Stock LLP in terms of the amount and type of non-audit work undertaken; whether an audit partner rotation would be sufficient in addressing any lack of independence; or whether a new audit firm should be appointed.

It is noted that the Chairman and CEO of Higgins do not agree in respect of the retention of Stock LLP. In its introduction, the FRC Guidance on audit committees states that the principle of a unitary board is not affected by the creation of an audit committee and all directors are equally responsible in law for the company's affairs. As the audit committee is a committee of the board, any disagreement within the board should be resolved at board level. A suggestion, therefore, would be that once a review of the independence and objectivity of Stock LLP has been undertaken (by the audit committee if this has been established, or by a number of the NEDs; the review should not be undertaken by the Chairman or the CEO) the findings should be discussed and debated by the board as whole with a view to making a decision on the most appropriate course of action.

Examiner's comments

Question 4 was the second most popular question, and in general was answered quite well.

For Question 4(a) many candidates did not identify all the requirements for the composition of an audit committee. Most candidates did provide a good level of detail in respect of the audit committee's role. There was also a significant amount of confusion as to whether the board chairman could, or could not, chair the audit committee.

Most candidates covered the wide range of responsibilities of the audit committee. Some candidates provided significant detail on the risk management and control responsibilities of an audit committee. Whilst marks were awarded for these areas, candidates were required to include details of other elements of the committee's role in order to gain a pass mark.

In Question 4(b) many candidates appeared to struggle to provide clear and concise advice on the issues with the current auditor in the scenario. Most candidates correctly highlighted the impact of certain factors (including the provision of non-audit work, as detailed in the scenario) on an external

auditor's independence. A common suggestion, and only focus of some answers, was to put the audit out to tender immediately and/or to remove the auditors. Whilst the question asked candidates to "advise", any such tender or removal would be a decision for the board to make.

Many candidates did not seem aware of audit firm or partner rotation and discussions on these areas would have gained additional marks.

- 5 David Castle recently joined Grove Ltd ('Grove'), a company in the telecommunications industry, as its new CEO and has highlighted his concerns over the lack of a whistleblowing policy and related procedures.

David has asked that you, as Company Secretary, prepare a paper for consideration by the board.

Required

Prepare a paper for the board of Grove in which you:

- (a) Define the terms 'whistleblower' and 'whistleblowing' and explain where responsibility for implementing and reviewing the whistleblowing policy should lie.

(5 marks)

Suggested answer

Definitions and responsibility

A whistleblower is an employee who provides information about their company that they reasonably believe provides evidence of such events as fraud, a serious violation of a law or regulation, offering or taking bribes or price fixing.

The British Standards Institute's (BSI) Whistleblowing Procedures: Code of Practice provides the following definition:

"Whistleblowing is the popular term used when someone who works in or for an organisation ... raises a concern about a possible fraud, crime, danger or other serious risk that could threaten customers, colleagues, shareholders, the public or the organisation's own reputation".

Provision c.3.5 of the UK Code states that the audit committee should be responsible for the review of arrangements to enable staff, in confidence, to raise concerns regarding possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

In addition, the Company Secretary will often be significantly involved in establishing the policy and procedures. Within the organisation it is necessary to have trained certain people in the operation of the procedures and to offer support to any employee reporting a genuine concern. Both of these roles, amongst others, could be undertaken by the Company Secretary, who should refer any concerns through the appropriate reporting lines.

- (b) Describe the best practice in establishing a whistleblowing policy and what the main features of a whistleblowing policy should be.

(9 marks)

Suggested answer

Features of a whistleblowing policy

A whistleblowing procedure is an internal control but its effectiveness depends on the willingness of genuine whistleblowers to come forward with their allegations.

The need for whistleblowing arises when normal procedures and internal controls will not reveal the illicit activity, due to the individuals responsible for the activity somehow being able to ignore or circumvent the normal controls. Illicit or illegal behaviour should be uncommon and, therefore, whistleblowing should be an occasional event.

A whistleblowing system should encourage employees to report illegal or unethical behaviour but should also discourage malicious and unfounded allegations.

The BSI's Whistleblowing Arrangements Code of Practice suggests that the main features of a whistleblowing policy should include:

- That it is documented and a copy should be given, or made available, to every employee.
- Key aspects of the procedure, including the person to whom employees should report their suspicions or concerns (for example, the company secretary or internal audit).
- A statement that the company takes malpractice or misconduct very seriously.
- A statement that the company is committed to a culture of transparency where employees can report legitimate concerns without fear of penalty or punishment.
- Details of the types of misconduct for which employees should use the procedure and the level of proof that is required.
- A clear statement that no employee will be victimised for raising a genuine concern. Victimisation for raising a qualified disclosure should be a disciplinary offence.
- Details of the procedure that will be followed to investigate an allegation.
- Details of the internal reporting procedures to follow and an alternate external reporting route.
- An undertaking that, as far as possible, whistleblowers will be informed about the outcome of their allegations and the action that has been taken.
- A statement that whistleblowers will be promised confidentiality as far as is possible.

It is also recommended (by the BSI's Code) that employee representatives should be involved in establishing the procedure and monitoring the implementation.

- (c) Discuss the concerns or problems with whistleblowing systems and any relevant solutions. (11 marks)

Suggested answer

Potential concerns and problems

Concerns about whistleblowing have increased in recent years for a number of reasons, including:

- Individual employees prepared to investigate matters further prior to reporting any allegations may discover information that they are not officially supposed to be aware of. Companies have become aware that they could be liable for information held as email messages in the files of employees.
- Despite laws being designed to protect them, whistleblowers run the risk of retaliation and it would appear that they are more likely to be dismissed than rewarded, particularly where information is passed to someone outside the company, such as the media. Whistleblowers may put their jobs, and even their careers, at risk. An employer taking action may claim that dismissing the employee was not related to the allegations made, or claim that the employee was dismissed because their statements were vindictive and untrue.
- In previous cases of whistleblowing (for example, Enron (2001), WorldCom (2002), Tesco (2014)) the public became aware not only that the companies were being mismanaged, but also that honest attempts by employees to reveal the problems were being disregarded by senior management.
- In practice, employees may feel obliged to take their concerns to someone outside the company (often anonymously) and they may risk the anger of the employer for breach of proper procedures if they are identified. An employee can be disciplined for making groundless complaints and allegations in bad faith about their employer.

Some suggested solutions in respect of the above problems could include:

- The company and its senior management being committed to the policy and procedures.
- Instilling a culture of honesty and integrity and the company enabling employees to report allegations externally where appropriate. There are some official whistleblowing channels that provide a way of reporting concerns to someone outside the employer organisation, which can be set up or outsourced by an employer to provide a confidential service to employees.
- The company taking any allegations seriously and investigating them in an appropriate manner before taking relevant action.
- The company having external advisers in place to deal with investigations (particularly where allegations are being made against senior executives/directors).

Examiner's comments

Question 5 was a popular question and had the second highest pass rate on the paper.

In general, candidates showed a good level of knowledge in respect of whistleblowing policies and processes.

In Question 5(a) most candidates correctly defined the terms and identified where responsibility should lie. However, many candidates did not refer to a whistleblower actually being an employee. Some candidates identified the company secretary as having responsibility for the policy, rather than the audit committee (or the board ultimately).

Many candidates' answers were far too lengthy for a 5 mark question.

Question 5(b) was answered very well, with candidates providing full and comprehensive details of the main features of a whistleblowing policy. Whilst most candidates' answers reflected the contents of the BSI's Whistleblowing Arrangements Code of Practice, very few actually referred to this or to the recommendation for employee representatives being involved in establishing and monitoring the implementation of a policy.

Answers to Question 5(c) often contributed to an overall fail grade on the question for many candidates, where adequate discussion of the concerns and problems with whistleblowing systems and solutions was lacking. Very often, where candidates were able to suggest problems encountered with systems they did not identify any relevant solutions.

- 6 (a) Explain what institutional shareholders are, how they operate and the provisions of the UK Stewardship Code 2010 which set out their responsibilities.

(8 marks)

Suggested answer

Institutional shareholders are organisations that have large amounts of funds to invest and put much of these funds into company shares.

In the UK, institutional investors include pension funds, insurance companies and collective investment institutions such as unit trust funds and open-ended investment companies.

These organisations operate in the interests of beneficiaries, such as members of pension schemes and holders of life assurance policies.

They may appoint agents to manage their investments and the investment management firms will be given responsibility for buying and selling investments for their client institutions within the framework of investment fund mandates that indicate how the money should be invested and how the shares should be voted.

Institutional investors may also use the service of proxy voting agencies, which offer research and voting services to institutional clients, and voting advisory services.

Principles of shareholder responsibilities have been developed for institutional investors by a number of organisations. Of most significance is the Institutional Shareholder Committee's (ISC) code of practice which was adopted and developed by the Financial Reporting Council (FRC) into the UK Stewardship Code 2010. The Code, which contains seven principles, was revised in 2012 and is seen by the FRC to be complementary to the UK Corporate Governance Code in promoting high-quality dialogue between institutional investors and UK listed companies.

The UK Stewardship Code is also applied on a "comply or explain" basis and organisations adopting the Code should provide statements on their website containing:

- a description of how the principles have been applied;
- disclosure of specific information that is required by the Code (under Provisions 1, 5, 6 and 7); and
- an explanation of any non-compliance with the Code.

The aim of the UK Stewardship Code is to enhance the quality of engagement between institutional investors and companies to help improve long term returns to shareholders and the efficient exercise of governance responsibilities. The Code sets out good practice on engagement with investee companies to which the FRC believes institutional investors should aspire.

- (b) Discuss the typical views of institutional shareholders on directors' remuneration.

(9 marks)

Suggested answer

The associations of institutional investors, including the ABI and PLSA (formerly NAPF), have developed strong views on directors' remuneration and have issued various guidelines and notices to their members. Such guidelines or notices often recommend voting against proposed shareholder resolutions relating to remuneration. It is common for the guidance from these associations to influence shareholder voting.

The principles and guidance of the Investment Association (formed in October 2014) are generally consistent with the UK Corporate Governance Code 2014, but some offer an interesting viewpoint from the institutional investor perspective.

On the role of the remuneration committee, the Investment Association principles state that shareholders expect the committee to “protect and promote the shareholders’ interests when setting executive remuneration” and that the committee should look at executive remuneration “in terms of the pay policy of the company as whole, pay and conditions elsewhere in the Group, and the overall costs to shareholders”.

In respect of the structure of remuneration packages, the Investment Association principles state that complexity is discouraged; incentive structures should have a long-term focus to account for the differing interests of executives and shareholders (regarding timescales and consequences of failure/corporate underperformance); a careful balance of fixed and variable pay should be sought with a high degree of deferral payments and measurement of long-term performance; provisions for clawbacks should be included; and executives should build up their own personal shareholding in the company to improve the alignment of interests with shareholders.

The guidelines issued by PLSA (which were revised in Nov 2015) suggest the circumstances in which a vote against a company’s remuneration policy or implementation report may be justified. Such circumstances are where: there seems to be an insufficient alignment between the interests of executives and shareholders; the targets for receiving bonuses or awards under long-term incentives schemes are not sufficiently stretching; no provisions for clawback exist; guaranteed pensionable, discretionary of “one-off” annual bonuses or termination payments exist or have been made; and the policy provides for a new share award scheme in addition to an existing scheme.

- (c) Evaluate the practical requirements, set out in the UK Corporate Governance Code 2014, for a board of directors to maintain a dialogue with major shareholders.

(8 marks)

Suggested answer

Practical requirements

The UK Code (Main Principle E.1) states that “there should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place”.

Dialogue with institutional shareholders should not only consist of regular, formal announcements to the stock market generally, but also of regular, informal contact. The main point of contact between shareholders and the board is the chairman, the CEO or the finance director. However, supporting principles of the UK Code make reference to the chairman ensuring that all the directors are made aware of the issues and concerns of major shareholders; and that the board should keep in touch with shareholder opinion in the most practical and efficient ways, whatever these may be.

The practical requirements for maintaining dialogue as stated under the UK Code are:

- The chairman should ensure that the views of shareholders are communicated to the board as a whole.
- The chairman should discuss strategy and governance with major shareholders.
- NEDs should be given the opportunity to attend existing meetings with major shareholders.
- If requested to attend meetings with major shareholders, NEDs should expect to attend them.
- The senior independent director should attend enough meetings with a range of major shareholders to listen to their views, in order to develop a balanced understanding of their concerns and views.

Examiner's comments

Question 6 was quite popular and was also answered quite well.

In Question 6(a) most candidates accurately explained who institutional shareholders are and how they operate. A common error was to name PLSA/ABI as institutional shareholders, whereas these are representative associations. Candidates' knowledge of the provisions of the UK Stewardship Code was of a high standard, with many setting out all seven in reasonable detail.

For Question 6(b) some candidates did appear to struggle with discussing typical views of directors' remuneration. Many candidates provided details of what remuneration packages should do and how they should be structured. Some of this detail was relevant, but did not deal directly with the question asked. This part of the question illustrated that candidates had either not understood the question or could not accurately apply principles in a focussed way, or use relevant examples to support their discussion.

In Question 6(c) some candidates limited the scope of their answers to the AGM and annual reporting, without reference to the wider requirements of actual dialogue with major shareholders. Candidates were required to discuss and evaluate methods of dialogue, including the different types of meetings that can be held with shareholders.

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.