ACCA Paper P1: GOVERNANCE, RISK AND ETHICS

Questions and Answers

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“Where shall I begin, please your majesty?” he asked. “Begin at the beginning,” the king said gravely, “and go on till you come to the end: then stop.”

Lewis Carroll
Through the Looking-Glass
I ask any lady reading these questions, answers and tutorial notes to be patient with my occasional use of the masculine pronoun in referring to the 'manager', the 'member of staff', the 'planner', and any other *dramatis personae* of the text, which I have used simply for grammatical convenience. I have a personal view that all general terms used in life, such as 'man in the street', 'manning the office', 'manpower', 'man-made' and so on should be de-masculinised as much as possible. This is not always easy when one is writing free-flowing text. Thank you.

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"Just look down the road and tell me if you can see either of them."
I see nobody on the road." said Alice.
I only wish I had such eyes, "the King remarked in a fretful tone. "To be able to see Nobody! And at such a distance too!"

Lewis Carroll
Alice in Wonderland

John Tenniel's illustration of the King and Queen of Hearts at the trial of the Knave of Hearts.
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Don’t raise your voice, improve your argument.

Bishop Desmond Tutu

*Address at the Nelson Mandela Foundation in Houghton, Johannesburg, South Africa, 23 November 2004*

**Desmond Tutu** (born 7 October 1931) is a South African social rights activist and retired Anglican bishop who rose to worldwide fame during the 1980s as an opponent of apartheid. He was the first black South African Archbishop of Cape Town and primate of the Church of the Province of Southern Africa (now the Anglican Church of Southern Africa).

Tutu's admirers see him as a man who since the demise of apartheid has been active in the defence of human rights and uses his high profile to campaign for the oppressed, though his consistent opposition to Israel and the United States has made him controversial. He has campaigned to fight AIDS, tuberculosis, poverty, racism, sexism, the imprisonment of Bradley Manning, homophobia and transphobia. He received the Nobel Peace Prize in 1984.
Chemco is a well-established listed European chemical company involved in research into, and the production of, a range of chemicals used in industries such as agrochemicals, oil and gas, paint, plastics and building materials. A strategic priority recognised by the Chemco board some time ago was to increase its international presence as a means of gaining international market share and servicing its increasingly geographically dispersed customer base. The Chemco board, which operated as a unitary structure, identified JPX as a possible acquisition target because of its good product ‘fit’ with Chemco and the fact that its geographical coverage would significantly strengthen Chemco’s internationalisation strategy. Based outside Europe in a region of growth in the chemical industry, JPX was seen by analysts as a good opportunity for Chemco, especially as JPX’s recent flotation had provided potential access to a controlling shareholding through the regional stock market where JPX operated.

When the board of Chemco met to discuss the proposed acquisition of JPX, a number of issues were tabled for discussion. Bill White, Chemco’s chief executive, had overseen the research process that had identified JPX as a potential acquisition target. He was driving the process and wanted the Chemco board of directors to approve the next move, which was to begin the valuation process with a view to making an offer to JPX’s shareholders. Bill said that the strategic benefits of this acquisition was in increasing overseas market share and gaining economies of scale.

While Chemco was a public company, JPX had been family owned and operated for most of its thirty-five year history. Seventy-five percent of the share capital was floated on its own country’s stock exchange two years ago, but Leena Sharif, Chemco’s company secretary suggested that the corporate governance requirements in JPX’s country were not as rigorous as in many parts of the world. She also suggested that the family business culture was still present in JPX and pointed out that it operated a two-tier board with members of the family on the upper tier. At the last annual general meeting, observers noticed that the JPX board, mainly consisting of family members, had ‘dominated discussions’ and had discouraged the expression of views from the company’s external shareholders. JPX had no non-executive directors and none of the board committee structure that many listed companies like Chemco had in place. Bill reported that although JPX’s department heads were all directors, they were not invited to attend board meetings when strategy and management monitoring issues were being discussed. They were, he said, treated more like middle management by the upper tier of the JPX board and that important views may not be being heard when devising strategy. Leena suggested that these features made the JPX board’s upper tier less externally accountable and less likely to take advice when making decisions. She said that board accountability was fundamental to public trust and that JPX’s board might do well to recognise this, especially if the acquisition were to go ahead.

Chemco’s finance director, Susan Brown advised caution over the whole acquisition proposal. She saw the proposal as being very risky. In addition to the uncertainties over exposure to foreign markets, she believed that Chemco would also have difficulties with integrating JPX into the Chemco culture and structure. While Chemco was fully compliant with corporate governance best practice, the country in which JPX was based had few corporate governance requirements. Manprit Randhawa, Chemco’s operations director, asked Bill if he knew anything about JPX’s risk exposure. Manprit suggested that the acquisition of JPX might expose Chemco to a number of risks that could not only affect the success of the proposed acquisition but also, potentially, Chemco itself. Bill replied that he would look at the risks in more detail if the Chemco board agreed to take the proposal forward to its next stage.

Finance director Susan Brown, had obtained the most recent annual report for JPX and highlighted what she considered to be an interesting, but unexplained, comment about ‘negative local environmental impact’ in its accounts. She asked chief executive Bill White if he could find out what the comment meant and whether JPX had any plans to make provision for any environmental impact. Bill White was able to report, based on his previous dealings with JPX, that it did not produce any voluntary environmental reporting. The Chemco board broadly supported the idea of environmental
reporting although company secretary Leena Sharif recently told Bill White that she was unaware of the meaning of the terms ‘environmental footprint’ and ‘environmental reporting’ and so couldn’t say whether she was supportive or not. It was agreed, however, that relevant information on JPX’s environmental performance and risk would be necessary if the acquisition went ahead.

Required:

(a) Evaluate JPX’s current corporate governance arrangements and explain why they are likely to be considered inadequate by the Chemco board.  

(b) Manprit suggested that the acquisition of JPX might expose Chemco to a number of risks. Illustrating from the case as required, identify the risks that Chemco might incur in acquiring JPX and explain how risk can be assessed. 

(c) Construct the case for JPX adopting a unitary board structure after the proposed acquisition. Your answer should include an explanation of the advantages of unitary boards and a convincing case FOR the JPX board changing to a unitary structure. 

(d) Explain FOUR roles of non-executive directors (NEDs) and assess the specific contributions that NEDs could make to improve the governance of the JPX board. 

(e) Write a memo to Leena Sharif defining ‘environmental footprint’ and briefly explaining the importance of environmental reporting for JPX. 

The true rule, in determining to embrace, or reject any thing, is not whether it have any evil in it; but whether it have more of evil, than of good. There are few things wholly evil, or wholly good.

Abraham Lincoln (1809-1865),
U.S. president.

Speech in the U.S. House of Representatives on internal improvements, June 20, 1848.
You are required to evaluate JPX’s current corporate governance arrangements and explain why they are likely to be considered inadequate by the board considering acquiring JPX.

Corporate governance implications

JPX’s history as a privately run family business may partly explain its apparent slowness to develop the corporate governance structures and systems expected in many parts of the world.

There were no non-executive directors (NEDs) on the JPX board.

There is evidence of a corporate culture at JPX dominated by the members of the family - that they dominate the upper tier of the board.

A wider participation in board membership is necessary.

The two-tier board raises concern because the department heads, who are on the lower tier of the board, are excluded from strategic discussions at board level.

It is likely that as line managers in the business, the departmental heads would have vital inputs to make into such discussions, especially on such issues as the implementation of strategies.

It could be argued that JPX’s reporting is less than ideal with, for example, its oblique reference to a ‘negative local environmental impact’.

It is likely that adjusting to the requirements of complying with the corporate governance European-centred demands of Chemco will present a challenge.

Answer plan for part (b) is on the next page
You are required to identify the risks that Chemco might incur in acquiring JPX and explain how risk can be assessed.

Risks of the propose acquisition

The case highlights a possible environmental risk (the ‘negative local environmental impact’) that may or may not be eventually valued as a provision (depending on whether or not it is likely to result in a liability).

Exchange rate risks apply to any business dealing with revenue or capital flows between two or more currency zones.

There is some market risk in Chemco’s valuation of JPX stock.

It is not certain that Chemco has full knowledge of the fair price to pay for each JPX share given the issues of dealing across national borders and in valuing stock in JPX’s country.

All mergers and acquisitions (‘integrations’) are exposed to synergy risks. Whilst it is expected and hoped that every merger or acquisition will result in synergies (perhaps from scale economies as the case mentions), in practice, many integrations fail to realise any.

In extreme cases, the costs arising from integration can threaten the very survival of the companies involved.

Finally, there are risks associated with the bringing-together of the two board structures.

Assessment of risk

The identity (nature and extent) of the risks facing the company should be identified (such as considering the risks involved in acquiring JPX).

The company should decide on the categories of risk that are regarded as acceptable for the company to bear.

The assessment of risk should quantify, as far as possible, the likelihood (probability) of the identified risks materialising.

An assessment of risk will entail an examination of the company’s ability to reduce the impact on the business of risks that do materialise.

Risk assessment involves an understanding of the costs of operating particular controls to review and manage the related risks.

For full answer (b) click here
Ask yourself …. What is being examined here?

You are required to Construct the case for JPX adopting a unitary board structure after the proposed acquisition.

A 10 mark question - in depth discussion is required

For full answer (c) click here

Advantages of unitary board structure in general

- NEDs are empowered, being accorded equal status to executive directors.
- Board accountability is enhanced by providing a greater protection against fraud and malpractice and by holding all directors equally accountable under a ‘cabinet government’ arrangement.
- Unitary board arrangements reduce the likelihood of abuse of (self-serving) power by a small number of senior directors.
- The fact that the board is likely to be larger than a given tier of a two-tier board means that more viewpoints are likely to be expressed in board deliberations and discussions.

Relevance to JPX in particular

- If the JPX acquisition was to proceed, there would be a unitary board at Chemco overseeing a two-tier board at JPX.
- A specific argument for JPX adopting a unitary board would be to bring it into line with Chemco’s board policy.
- There is an argument for making changes at JPX in order to signal a departure from the ‘old’ systems when JPX was independent of the ‘new’ systems under Chemco’s ownership.
- It is clear that the family members who currently run JPX have a disproportionate influence on the company and its strategy (the ‘family business culture’). Widening the board would, over time, change the culture of the board and reduce that influence.
- A unitary board structure would empower the departmental heads at JPX whose opinions and support are likely to be important.

Answer plan for part (d) is on the next page
You are required to explain FOUR roles of non-executive directors (NEDs) and assess the specific contributions that NEDs could make.

**Four roles of non-executive directors.**

The **strategy role** recognises that NEDs are full members of a unitary board and thus have the right and responsibility to contribute to the strategic success of the organisation for the benefit of shareholders.

In the **scrutinising role**, NEDs are required to hold executive colleagues to account for decisions taken and results obtained.

The **risk role** involves NEDs ensuring the company has an adequate system of internal controls and systems of risk management in place.

Finally, the ‘**people’ role** involves NEDs overseeing a range of responsibilities with regard to the management of the executive members of the board. This typically involves issues on appointments and remuneration.

**Specific benefits for JPX of having NEDs**

The specific benefits that NEDs could bring to JPX concern the need for a balance against excessive family influence and the prior domination of the ‘family business culture’.

NEDs will perform an important role in representing external shareholders’ interests (as well as internal shareholders).

Chemco’s own board discussion included Bill White’s view that the exclusion of departmental heads was resulting in important views not being heard when devising strategy. This is a major potential danger to JPX.
For full answer (e) click here

**Definition of ‘environmental footprint’**

In the same way that humans and animals leave physical footprints that show where they have been, so organisations such as Chemco leave evidence of their operations in the environment.

The environmental footprint is an attempt to evaluate the size of Chemco’s impact on the environment in three respects:

1. the company's resource consumption where resources are defined in terms of inputs such as energy, feedstock, water, land use, etc.
2. any harm to the environment brought about by pollution emissions. These include emissions of carbon and other chemicals, local emissions, spillages, etc.
3. the environmental footprint includes a measurement of the resource consumption and pollution emissions.

**Arguments for environmental reporting at JPX**

Recognition of the importance of observing the corporate governance and reporting principles of transparency, openness, responsibility and fairness wherever possible.

It is important to present a balanced and understandable assessment of the company's position and prospects to external stakeholders.

There is a need to explain in more detail the 'negative local environmental impact' and an environmental report would be an ideal place for such an explanation.
(a) JPX’s current corporate governance arrangements

Inadequacy of JPX’s current corporate governance arrangements
The case highlights a number of ways in which the corporate governance at JPX is inadequate. JPX’s history as a privately run family business may partly explain its apparent slowness to develop the corporate governance structures and systems expected in many parts of the world. There are five ways, from the case, that JPX can be said to be inadequate in its corporate governance although these are linked. There is overlap between the points made.

In the first instance, the case mentions that there were no non-executive directors (NEDs) on the JPX board. It follows that JPX would be without the necessary balance and external expertise that NEDs can provide. Second, there is evidence of a corporate culture at JPX dominated by the members of the family. The case study notes that they dominate the upper tier of the board. This may have been acceptable when JPX was a family owned company, but as a public company floated on a stock exchange and hence accountable to external shareholders, a wider participation in board membership is necessary. Third, the two-tier board, whilst not necessarily being a problem in itself (two-tier boards work well in many circumstances), raises concern because the department heads, who are on the lower tier of the board, are excluded from strategic discussions at board level. It is likely that as line managers in the business, the departmental heads would have vital inputs to make into such discussions, especially on such issues as the implementation of strategies. It is also likely that their opinions on the viabilities of different strategic options would be of value. Fourth, it could be argued that JPX’s reporting is less than ideal with, for example, its oblique reference to a ‘negative local environmental impact’. However, it might be noted that ambiguity in reporting is also evident in European and American reporting. Finally, having been subject to its own country’s less rigorous corporate governance requirements for all of its previous history, it is likely that adjusting to the requirements of complying with the European-centred demands of Chemco will present a challenge.

(b) Risks of the proposed acquisition

Risks that Chemco might incur in acquiring JPX.
The case describes a number of risks that Chemco could become exposed to if the acquisition was successful. Explicitly, the case highlights a possible environmental risk (the ‘negative local environmental impact’) that may or may not be eventually valued as a provision (depending on
whether or not it is likely to result in a liability). Other risks are likely to emerge as the proposed acquisition develops. Exchange rate risks apply to any business dealing with revenue or capital flows between two or more currency zones. The case explicitly describes Chemco and JPX existing in different regions of the world. Whilst exchange rate volatility can undermine confidence in cash flow projections, it should also be borne in mind that medium term increases or decreases in exchange values can materially affect the returns on an investment (in this case, Chemco’s investment in JPX). There is some market risk in Chemco’s valuation of JPX stock. This could be a substantial risk because of JPX’s relatively recent flotation where the market price of JPX may not have yet found its intrinsic level. In addition, it is not certain that Chemco has full knowledge of the fair price to pay for each JPX share given the issues of dealing across national borders and in valuing stock in JPX’s country. All mergers and acquisitions (‘integrations’) are exposed to synergy risks. Whilst it is expected and hoped that every merger or acquisition will result in synergies (perhaps from scale economies as the case mentions), in practice, many integrations fail to realise any. In extreme cases, the costs arising from integration can threaten the very survival of the companies involved. Finally, there are risks associated with the bringing-together of the two board structures. Specifically, structural and cultural changes will be required at JPX to bring it in line with Chemco’s. The creation of a unitary board and the increased involvement of NEDs and departmental heads may be problematic, for example, Chemco’s board is likely to insist on such changes post-acquisition.

**Tutorial comment**

It could be argued that JPX’s reporting is less than ideal with, for example, its oblique reference to a ‘negative local environmental impact’.

Indeed, some jurisdictions require the environmental impact of corporate proposals to be produced as an official statement.

For example, an environmental impact statement (EIS), under United States environmental law, is a document required by the National Environmental Policy Act (NEPA) for certain actions "significantly affecting the quality of the human environment". An EIS is a tool for decision making. It describes the positive and negative environmental effects of a proposed action, and it usually also lists one or more alternative actions that may be chosen instead of the action described in the EIS.

**End of tutorial comment**

**Explanation of business synergy**

The concept that the value and performance of two companies combined will be greater than the sum of the separate individual parts. **Synergy** is a term that is most commonly used in the context of mergers and acquisitions. Synergy, or the potential financial benefit achieved through the combining of companies, is often a driving force behind a merger. Shareholders will benefit if a company’s post-merger share price increases due to the synergistic effect of the deal. The expected synergy achieved through the merger can be attributed to various factors, such as increased revenues, combined talent and technology, or cost reduction.

Mergers and acquisitions are made with the goal of improving the company’s financial performance for the shareholders. Two businesses can merge to form one company that is capable of producing more revenue than either could have been able to independently, or to create one company that is able to eliminate or streamline redundant processes, resulting in significant cost reduction. Because of this principle, the potential synergy is examined during the merger and acquisition process. If two companies can merge to create greater efficiency or scale, the result is what is sometimes referred to as a **synergy merge**.
Assessment of risk
The assessment of the risk exposure of any organisation has five components. Firstly, the identity (nature and extent) of the risks facing the company should be identified (such as considering the risks involved in acquiring JPX). This may involve consulting with relevant senior managers, consultants and other stakeholders. Second, the company should decide on the categories of risk that are regarded as acceptable for the company to bear. Of course any decision to discontinue exposure to a given risk will have implications for the activities of the company and this cost will need to be considered against the benefit of the reduced risk. Third, the assessment of risk should quantify, as far as possible, the likelihood (probability) of the identified risks materialising. Risks with a high probability of occurring will attract higher levels of management attention than those with lower probabilities. Fourth, an assessment of risk will entail an examination of the company’s ability to reduce the impact on the business of risks that do materialise. Consultation with affected parties (e.g. departmental heads, stakeholders, etc.) is likely to be beneficial, as information on minimising negative impact may sometimes be a matter of technical detail. Fifth and finally, risk assessment involves an understanding of the costs of operating particular controls to review and manage the related risks. These costs will include information gathering costs, management overhead, external consultancy where appropriate, etc.

(c) Unitary and two-tier board structures

Advantages of unitary board structure in general
There are arguments for and against unitary and two-tier boards. Both have their ‘place’ depending on business cultures, size of business and a range of other factors. In general, however, the following arguments can be put for unitary boards.

One of the main features of a unitary board is that all directors, including managing directors, departmental (or divisional) directors and NEDs all have equal legal and executive status in law. This does not mean that all are equal in terms of the organisational hierarchy, but that all are responsible and can be held accountable for board decisions. This has a number of benefits. Firstly, NEDs are empowered, being accorded equal status to executive directors. NEDs can bring not only independent scrutiny to the board, but also experience and expertise that may be of invaluable help in devising strategy and the assessment of risk. Second, board accountability is enhanced by providing a greater protection against fraud and malpractice and by holding all directors equally accountable under a ‘cabinet government’ arrangement. These first two benefits provide a major underpinning to the confidence that markets have in listed companies. Third, unitary board arrangements reduce the likelihood of abuse of (self-serving) power by a small number of senior directors. Small ‘exclusivist’ boards such as have been evident in some corporate ‘scandals’ are discouraged by unitary board arrangements. Fourth, the fact that the board is likely to be larger than a given tier of a two-tier board means that more viewpoints are likely to be expressed in board deliberations and discussions. In addition to enriching the intellectual strength of the board, the inclusivity of the board should mean that strategies are more robustly scrutinised before being implemented.

Relevance to JPX in particular
If the JPX acquisition was to proceed, there would be a unitary board at Chemco overseeing a two-tier board at JPX. The first specific argument for JPX adopting a unitary board would be to bring it into line with Chemco’s. Chemco clearly believes in unitary board arrangements and would presumably prefer to have the benefits of unitary boards in place so as to have as much confidence as possible in JPX’s governance. This may be especially important if JPX is to remain an ‘arms length’ or decentralised part of Chemco’s international operation. Second, there is an argument for making changes at JPX in order to signal a departure from the ‘old’ systems.
when JPX was independent of the ‘new’ systems under Chemco’s ownership. A strong way of helping to ‘unfreeze’ previous ways of working is to make important symbolic changes and a rearrangement of the board structure would be a good example of this. Third, it is clear that the family members who currently run JPX have a disproportionate influence on the company and its strategy (the ‘family business culture’). Widening the board would, over time, change the culture of the board and reduce that influence. Fourth, a unitary board structure would empower the departmental heads at JPX whose opinions and support are likely to be important in the transition period following the acquisition.

(d) Non executive directors

Four roles of non-executive directors.
The Higgs Report (2003) in the United Kingdom helpfully described the function of non-executive directors (NEDs) in terms of four distinct roles. These were the strategy role, the scrutinising role, the risk advising role and the ‘people’ role. These roles may be undertaken as part of the general discussion occurring at Board meetings or more formally, through the corporate governance committee structure.

The strategy role recognises that NEDs are full members of a unitary board and thus have the right and responsibility to contribute to the strategic success of the organisation for the benefit of shareholders. In this role they may challenge any aspect of strategy they see fit, and offer advice or input to help to develop successful strategy.

In the scrutinising role, NEDs are required to hold executive colleagues to account for decisions taken and results obtained. In this respect they are required to represent the shareholders’ interests against the possibility that agency issues arise to reduce shareholder value.

The risk role involves NEDs ensuring the company has an adequate system of internal controls and systems of risk management in place. This is often informed by prescribed codes (such as Turnbull) but some industries, such as chemicals, have other systems in place, some of which fall under International Organisation for Standardisation (ISO) standards.

Finally, the ‘people’ role involves NEDs overseeing a range of responsibilities with regard to the management of the executive members of the board. This typically involves issues on appointments and remuneration, but might also involve contractual or disciplinary issues.

Specific benefits for JPX of having NEDs

The specific benefits that NEDs could bring to JPX concern the need for a balance against excessive family influence and the prior domination of the ‘family business culture’. Chemco, as JPX’s new majority shareholder, is unlikely to want to retain a ‘cabal’ of an upper tier at JPX and the recruitment of a number of NEDs will clearly help in that regard. Second, NEDs will perform an important role in representing external shareholders’ interests (as well as internal shareholders). Specifically, shareholders will include Chemco. Third, Chemco’s own board discussion included Bill White’s view that the exclusion of departmental heads was resulting in important views not being heard when devising strategy. This is a major potential danger to JPX and NEDs could be appointed to the board in order to ensure that future board discussions include all affected parties including the previously disenfranchised department heads.

(e) Environmental reporting.

Memorandum

From: Professional Accountant
To: Leena Sharif
Date: DD/MM/YYYY

Re: environmental issues at Chemco and JPX

1. Introduction

I have been asked to write to you on two matters of potential importance to Chemco in respect of environmental issues. The first of these is to consider the meaning of the term, ‘environmental footprint’ and the second is to briefly review the arguments for inviting JPX (should the acquisition proceed) to introduce environmental reporting.
2. ‘Environmental footprint’

Explanation of ‘environmental footprint’
The use of the term ‘footprint’ with regard to the environment is intended to convey a meaning similar to its use in everyday language. In the same way that humans and animals leave physical footprints that show where they have been, so organisations such as Chemco leave evidence of their operations in the environment. They operate at a net cost to the environment. The environmental footprint is an attempt to evaluate the size of Chemco’s impact on the environment in three respects. Firstly, concerning the company’s resource consumption where resources are defined in terms of inputs such as energy, feedstock, water, land use, etc. Second, concerning any harm to the environment brought about by pollution emissions. These include emissions of carbon and other chemicals, local emissions, spillages, etc. It is likely that as a chemical manufacturer, both of these impacts will be larger for Chemco than for some other types of business. Thirdly, the environmental footprint includes a measurement of the resource consumption and pollution emissions in terms of harm to the environment in either qualitative, quantitative or replacement terms.

3. Environmental reporting at JPX

Arguments for environmental reporting at JPX
There are number of arguments for environmental reporting in general and others that may be specifically relevant to JPX. In general terms and firstly, I’m sure as company secretary you will recognise the importance of observing the corporate governance and reporting principles of transparency, openness, responsibility and fairness wherever possible. We should invite JPX to adopt these values should the acquisition proceed. Any deliberate concealment would clearly be counter to these principles and so ‘more’ rather than ‘less’ reporting is always beneficial. Second, it is important to present a balanced and understandable assessment of the company’s position and prospects to external stakeholders. Third, it is important that JPX recognises the existence and size of its environment footprint, and reporting is a useful means if doing this. Fourth, and specifically with regard to JPX and other companies with a substantial potential environmental footprint, there is a need to explain environmental strategy to investors and other interested stakeholders (e.g. Chemco). Finally, there is a need to explain in more detail the ‘negative local environmental impact’ and an environmental report would be an ideal place for such an explanation.

Summary:
As JPX’s ‘environmental footprint’ is potentially quite large, it is important that Chemco ensures as far as possible, that any such footprint left by JPX is known and measured. Additionally, in the interests of transparency, openness, responsibility and fairness, it is important that it is also fully reported upon for the information of both investors and other interested stakeholders.
The Lord above gave man an arm of iron
So he could do his job and never shirk.
The Lord gave man an arm of iron—but
With a little bit of luck, With a little bit of luck,
Someone else'll do the blinkin’ work!

With a little bit...with a little bit...
With a little bit of luck you’ll never work!

With a Little Bit O’ Luck
from the musical
My Fair Lady

Theatrical release poster by Bill Gold,
original illustration by Bob Peak
Diagnostic Test

Governance and responsibility
Questions
Question 1
Define corporate governance. (1 mark)

Question 2
Give six features of poor governance. (7 marks)

Question 3
Why do investors tend to be inactive shareholders of companies? (1 mark)

Question 4
What is meant by aligning the interests of executives and shareholders. (1 mark)

Question 5
Can shareholders influence management decisions? (1 mark)

Question 6
To appreciate what corporate governance is, it is helpful to be aware of what it is not. State two aspects of running a company that corporate governance is not concerned with. (2 marks)

Question 7
Why is corporate governance important? (2 marks)

Question 8
The need for good corporate governance is a matter of international concern even though the pace of change and the nature of corporate governance vary substantially between countries.

State three reasons why corporate governance has become a matter of some concern in many countries. (3 marks)

Question 9
Apart from attending and voting at AGMs in what four ways do investors interact with the company and monitor manager activities. (4 marks)

Question 10
Over the two decades between 1990 and 2010 external auditors became less confrontational with the management of their client companies. Why was this so? (2 marks)
Question 11
In what ways, which emphasise the need for strong corporate governance, has the role of accounting departments within companies changed during the past two to three decades. (2 marks)

Question 12
Discuss the potential conflict of interest that may exist between a business consulting firm and its corporate client. (3 marks)

Question 13
What is a stakeholder group? (1 mark)

Question 14
What is a majority shareholder? (1 mark)

Question 15
What is a minority shareholder? (1 mark)

Question 16
What is an executive director? (1 mark)

Question 17
What is an institutional shareholder (1 mark)

Question 18
Most corporate governance codes are based on a set of principles founded upon ideas of what corporate governance is meant to achieve. List six aims of corporate governance. (6 marks)

Question 19
The UK Financial Reporting Council issued the ‘UK Corporate Governance Code’. Briefly discuss six guidelines that specifically relate to the board of directors and its functioning. (6 marks)

Question 20
List six roles of a board of directors. (6 marks)
Question 21
A number of reports have been produced in various countries aiming to address the risk and problems posed by poor corporate governance. Here we concentrate specifically on UK reports the findings much of which are incorporated in the UK Corporate Governance Code. You are required to insert the author’s name against the focus of each particular report.

3. ‘The G......... Report’ focus: remuneration of directors
4. ‘The T........... Report’ focus: risk management and internal control
5. ‘The S...........Report’ focus: independence of auditors
7. ‘The M……… Report’ focus: attention given to institutional investors (7 marks)

Question 22
Why is the corporate takeover market an important disciplinary force for managers? (1 mark)

Question 23
Identify and briefly explain four anti-takeover devices which might be employed for the benefit of the management of a company without necessarily improving the wealth of the company’s shareholders. (4 marks)

Question 24
‘A problem, with some boards, is that directors do not have a significant vested interest in the firm. For example, directors own few or no shares in their companies.’ Briefly discuss whether investors should worry about the lack of share ownership of some of their directors. (1 mark)

Question 25
‘The problem is that some directors simply do not have the expertise to be a board member.’ Briefly discuss this statement. (1 mark)

Question 26
‘A potential problem is that some directors are incapable of providing the time and expertise required to understand fully and to approve the major operating and financial decisions of the company.’ Briefly discuss this statement. (1 mark)

Question 27
‘Some boards are simply too big, which makes it unlikely that all directors will be actively involved.’ Briefly discuss this statement. (1 mark)

Question 28
Summarising the points raised in Questions 24 – 27 above, many problems plague boards today. Directors may own few shares in their companies, simply do not have board expertise, are incapable of providing the time and expertise to understand fully and approve the decisions of their companies, while at the same time sitting on boards that are just too big! ‘However the most significant problem may be that directors might not be truly independent.’ Briefly discuss this last statement. (2 marks)
Question 29
Corporate governance is a multi-faceted subject which basically covers three main aspects. What are these aspects? (3 marks)

Question 30
The view of corporate governance is that it is based on a series of underlying concepts, such as transparency and openness. Briefly state eight other underlying concepts. (4 marks)

Question 31
A key issue in corporate governance is the duties of directors. Briefly identify another nine key issues. (9 marks)

Question 32
In the context of corporate governance, what is meant by transparency? (1 mark)

Question 33
State seven reasons why transparency is an important concept for effective corporate governance. (7 marks)

Question 34
In the context of corporate governance, what is meant by independence? (1 mark)

Question 35
In the context of corporate governance, identify six forms of independence. (6 marks)

Question 36
In the context of corporate governance, what is meant by integrity? (1 mark)

Question 37
Integrity can be taken as, 'Straightforwardness in relationships with different people'. State four other attributes that demonstrate integrity. (4 marks)

Question 38
In the context of corporate governance, what is meant by reputation? (1 mark)

Question 39
Briefly describe six possible consequences for a company having a poor reputation. (6 marks)
Question 40
Briefly describe five key characteristics of the principles-based approach to corporate governance. (5 marks)

Question 41
Briefly describe five key characteristics of the rules-based approach to corporate governance. (5 marks)

Question 42
Briefly discuss five advantages of a principles-based approach to corporate governance. (5 marks)

Question 43
Briefly discuss five criticisms levelled against a principles-based approach to corporate governance. (5 marks)

Question 44
One generally accepted way of categorising corporate governance systems is the ‘insider/outsider’ model. Briefly explain an insider model of corporate governance. (1 mark)

Question 45
In the context of corporate governance, briefly discuss four advantages of insider systems. (4 marks)

Question 46
In the context of corporate governance, briefly discuss seven criticisms of insider systems. (7 marks)

Question 47
One generally accepted way of categorising corporate governance systems is the ‘insider/outsider’ model. Briefly explain an outsider model of corporate governance. (1 mark)

Question 48
In the context of corporate governance, briefly discuss four advantages and two disadvantages of outsider systems. (6 marks)

Question 49
In the context of corporate governance, explain agency theory. (1 mark)

Question 50
Assumptions can be made about the behaviour of directors acting as ‘agents’ for shareholders who are the ‘principals’. Give examples of five such assumptions. (5 marks)
Question 51
In the context of agency theory, what is meant by **accountability**? (1 mark)

Question 52
Directors have a **fiduciary duty** to their company. What does fiduciary duty mean? (1 mark)

Question 53
Give six examples of **fiduciary duty**. (6 marks)

Question 54
What are **agency costs**? (1 mark)

Question 55
Shareholders, as principals, incur **agency costs** which are the costs of monitoring what the directors and company are doing. This is required because of the **separation of ownership and management**. Give 9 examples of agency costs incurred by shareholders. (9 marks)

Question 56
Explain how **transaction cost theory** could relate to **agency theory**. (2 marks)

Question 57
There has been considerable debate about what the objectives of sound corporate governance should be in regard to a company’s stakeholders. The different views can be divided into two broad groups: the **pristine capitalist** (or **stakeholder value**) position, and **social contractarian** (or **enlightened stakeholders**) position. 

Explain the following:
(a) **pristine capitalist** position (1 mark)
(b) **social contractarian** position. (1 mark)

Question 58
Define **stakeholders**. (2 marks)

Question 59
Briefly discuss the following statements:
(a) ‘Companies are developing a social conscience.’ (2 marks)
(b) ‘Employee pressure is becoming more influential.’ (2 marks)
(c) ‘Pressure groups exert influence.’ (2 marks)
Question 60
Define internal stakeholders and identify six examples of internal stakeholders. (3 marks)

Question 61
Define connected stakeholders and identify five examples of connected stakeholders. (3 marks)

Question 62
Define external stakeholders and give examples. (3 marks)

Question 63
Distinguish between direct and indirect stakeholders. (4 marks)

Question 64
Distinguish between legitimate and illegitimate stakeholders. (4 marks)

Question 65
Distinguish between narrow and wider stakeholders. (4 marks)

Question 66
Distinguish between voluntary and involuntary stakeholders. (4 marks)

Question 67
Distinguish between active and passive stakeholders. (4 marks)

Question 68
Distinguish between known and unknown stakeholders. (4 marks)

Question 69
Briefly describe the roles and interests of the following groups of stakeholders:

(a) Supplier (1 mark)
(b) Trade unions (1 mark)
(c) Executives and other managers (1 mark)
(d) External auditors (1 mark)
(e) Regulators (1 mark)
(f) Customers (1 mark)
(g) Owners and shareholders (1 mark)
(h) Directors (1 mark)
(i) Employees. (1 mark)
Question 70
Describe what is involved in stakeholder mapping. (2 marks)

Question 71
For stakeholders to have power and influence, their desire to exert influence must be combined with their ability to exert influence on the business.
The power a stakeholder can exert will reflect the extent of what? (3 marks)

Question 72
Each shareholder group, to a greater or lesser extent, will influence a company's strategy and exert its own degree of power. It is therefore important that a company's strategic planning process includes an analysis of the needs and expectations of each of its external groups, and the extent of power that the group exerts and its sources. Notwithstanding your answer to Question 71 briefly describe three sources of power of stakeholders. (1 mark)

Question 73
Briefly explain how assessing the predictability of stakeholders' behaviour to change is part of stakeholder mapping. (1 mark)

Question 74
Briefly explain how assessing the interest of stakeholders’ to change is part of stakeholder mapping. (1 mark)

Question 75
The following diagram is used to demonstrate Mendelow's 'Power/Predictability' matrix. Briefly discuss how this analytical model could be used as part of stakeholder analysis (or stakeholder mapping).

STAKEHOLDER MAPPING: POWER/PREDICTABILITY MATRIX

PREDICTABILITY
LOW    High

POWER
Low    A    B
High    C    D
**Question 76**
The following diagram is used to demonstrate Mendelow’s ‘Power/Interest’ matrix. Briefly discuss how this analytical model could be used as part of stakeholder analysis (or stakeholder mapping)

![Power/Interest Matrix Diagram](image)

(4 marks)

**Question 77**
Briefly discuss five problems associated with the process of stakeholder mapping. (5 marks)

**Question 78**
Excluding the owners and shareholders, the needs of the other stakeholders of a company might be viewed as a hierarchy. Describe such a hierarchy. (4 marks)

**Question 79**
There are often areas where stakeholder interests are aligned (in agreement) – where a decision can benefit more than one stakeholder group. Briefly describe four examples of how stakeholders’ interests may be aligned. (4 marks)

**Question 80**
On the other hand, there is often conflict between stakeholders’ goals. Give four examples of such conflict. (4 marks)

**Question 81**
Briefly describe what is meant by a unitary board of directors. (1 mark)
Question 82
Briefly describe what is meant by a **two-tier** board of directors structure. (1 mark)

Question 83
Discuss four advantages of **unitary boards**. (4 marks)

Question 84
Discuss four disadvantages of **unitary boards**. (4 marks)

Question 85
Discuss four advantages of **multi-tier boards**. (4 marks)

Question 86
Discuss four disadvantages of **multi-tier boards**. (4 marks)

Question 87
The board is likely to have met its duty of care if it meets certain requirements. Give examples of eight such requirements. (8 marks)

Question 88
Describe the role of the chairman of the board of directors. (5 marks)

Question 89
Describe a non-executive director (NED). (2 marks)

Question 90
Various **safeguards** can be put in place to ensure that **non-executive directors remain independent**. Identify five such safeguards. (5 marks)

Question 91
Non-executive directors bring advantages to the work of a board of directors. State eight such advantages. (8 marks)

Question 92
Give six examples of six problems associated with the role of non-executive directors. (6 marks)

Question 93
The UK Higgs report summed up the characteristics of the **effective** non-executive director by suggesting six characteristics. What are they? (6 marks)
**Question 94**
Higgs also suggested that nine issues were involved when appraising the performance of non-executive directors. What are these issues? (9 marks)

**Question 95**
The International Corporate Governance Network (ICGN) issued guidance on the remuneration of non-executive directors in 2010. The guidance states what non-executive directors should **not** receive. List six benefits that non-executive should **not** receive from the company. (6 marks)

**Question 96**
There are no statutory requirements to establish board committees, but four committees are recommended by many codes of good corporate governance. What are these four committees? (4 marks)

**Question 97**
State eight responsibilities of a board’s remuneration committee. (8 marks)

**Question 98**
State six factors that the remuneration committee would need to consider. (6 marks)

**Question 99**
Briefly describe the guidelines on the remuneration of directors contained in The UK Corporate Governance Code. (6 marks)

**Question 100**
Issues concerned with remuneration policy may include a number of factors. Briefly describe five factors. (5 marks)

**Question 101**
The UK Greenbury Report highlighted a number of factors which the remuneration committee should consider. Briefly describe six factors highlighted in the report. (6 marks)

**Question 102**
The UK Corporate Governance Code points out the need for directors to treat comparisons between sector organisations with caution, in view of the risk of an upward ratchet in remuneration levels with no corresponding improvement in performance. The emphasis needs to be on remuneration committees asking searching questions about the data they are given. Discuss five aspects that should be considered when using the data. (5 marks)

**Question 103**
Directors being paid excessive salaries and bonuses has been seen as one of the major corporate abuses for many years. It is inevitable that the corporate governance provisions have targeted it. However this is not necessarily to the disadvantage of the high-performing director, since guidance issued has been unpinned by a distinction between reasonable rewards that are justified by performance, and high rewards that are not justified and are seen as unethical.

The Greenbury committee in the UK set out three key principles which are a good summary of what remuneration policy should involve. What are they? (3 marks)
Question 104
State five duties of the members of an Audit Committee. (5 marks)

Question 105
If the audit committee operates effectively it can bring significant benefits. List five such benefits. (Note: the question refers to benefits and not aims.) (5 marks)

Question 106
Give six aims of an audit committee. (6 marks)

Question 107
Remuneration packages for executive directors will need to attract, retain and motivate directors of sufficient quality, whilst at the same time taking into account shareholders’ interests as well.

Briefly describe four important factors that the remuneration committee would need to take into account when developing the remuneration package. (4 marks)

Question 108
Briefly describe eight aspects that the nominations committee of a board would be concerned about. (8 marks)

Question 109
The concepts described in the main corporate governance codes, such as the UK Corporate Governance Code apply to public sector and not-for-profit entities, as well as to companies. This is evident in Nolan’s Seven Principles of Public Life. Theses were issued in the UK by the Nolan Committee on Standards in Public Life, which was set up in 1995 to report on standards of behaviour amongst politicians and in the civil service and other public sector bodies.

The seven principles are listed below. You are required to suggest what each of these principles means and how they should be applied by a person holding a public office:

(i) selflessness
(ii) integrity
(iii) objectivity
(iv) accountability
(v) openness
(vi) honesty
(vii) leadership. (7 marks)
END OF THE DIAGNOSTIC TEST FOR GOVERNANCE AND RESPONSIBILITY
Diagnostic Test

Governance and responsibility
Answer Guides
Answer to Question 1
'Corporate governance is the system by which organisations are directed and controlled'.
(Cadbury Report, 1992)

Corporate governance refers to the way in which companies are governed, and to what purpose. It is concerned with practices and procedures for trying to ensure that a company is run in such a way that it achieves its objectives. This could be to maximise the wealth of its owners (the shareholders), subject to various guidelines and constraints and with regard to other groups with an interest in what the company does. Guidelines and constraints include behaving in an ethical way and in compliance with rules and regulations.

Answer to Question 2
Features of poor governance include the following:
B Board balance is poor and inadequate.
A Adequacy of internal controls is questionable.
S Supervision of work is lacking.
I Independent scrutiny of financial statements does not exist.
C Correctness of appointments to the board and the senior management team is questionable.
I Involvement of the full board in corporate decisions is not taking place.
L Long terms aims are being superseded by the short-term personal agendas of the directors.
L Liaison and contact with shareholders is weak.
S Strength of accounts and information is lacking.

Remember the mnemonic: BASIC ILLS

Answer to Question 3
Most shareholders do not wish to take part in a firm's business activities. These shareholders act like investors and not owners. The difference is subtle, but important. Owners focus on the business performance of the firm and investors focus on the risk and return of their stock portfolio. While diversifying reduces risk for the investor, ownership of many companies also makes participation and influence in those companies less likely. Therefore, investors tend to be inactive shareholders of many firms.

Answer to Question 4
Aligning the interests of executives and shareholders tend to relate to two categories, incentives and monitoring. The incentive solution is to tie the wealth of the executive to the wealth of the shareholders, so that executives and shareholders want the same thing. This is called aligning executive incentives with shareholders desires. (It is also called ‘goal congruence.’) Managers would then act and behave in a way that is also best for the other shareholders. How can this be done? For most listed companies, executives are given shares, share options, or both as a significant component of their compensation.

Answer to Question 5
Theoretically, managers work for owners (shareholders). In reality, because shareholders are usually inactive, the firm actually seems to belong to management. Some active shareholders have tried to influence management, but they have often met defeat. Recent evidence of unsuccessful outcomes of shareholder proposals is quite telling. Shareholders have the power to make proposals that can be voted on at the annual shareholders meeting. There are generally two types of proposals, those related to governance (e.g., suggesting changes in board structure) and those oriented to social reform (e.g., proposing to stop selling chemicals to rogue countries). About half of all shareholder-initiated proposals progress far enough in the process to reach the voting stage. When there is a vote, such proposals usually are defeated. (Reference: Stuart Gilland and Laura Starks 'A Survey of Shareholder Activism: Motivation and Empirical Evidence'.) A huge factor in whether a proposal is successful depends on management's opinion. Without management approval, proposals have little chance of succeeding. Traditionally, shareholders have trusted management to know what is best for the firm.

For two illustrative examples see the next page.
Apple Computer was cofounded by Steve Jobs. When the firm became a public corporation, Jobs was the largest shareholder, and he also became the CEO. However, the Apple board of directors felt that Jobs was not experienced enough to steer the firm through its rapid expansion. Therefore, they hired John Sculley as CEO in 1983. In 1985, a power struggle ensued for control of the firm, and the board backed Sculley. Jobs was forced out of Apple and no longer had a say in business operations even though he was the largest shareholder. (Interestingly, when Apple Computer experienced difficulties in the late 1990s, the board hired Jobs back as CEO!) (http://en.wikipedia.org/wiki/History_of_Apple_Inc.)

Answer to Question 6
To appreciate what corporate governance is, it is helpful to be aware of what it is not:

- Corporate governance is not primarily concerned with day-to-day management of operations by business executives. The powers of executive managers to direct business operations are one aspect of governance, but management skills are not.

- Similarly, corporate governance is not concerned with formulating business strategy, although the responsibility of the board of directors and executive managers for taking strategic decisions is.

Answer to Question 7
Although a company exists as a legal person, in reality it is the organised, collective effort of many different individuals. It is controlled by a board of directors, in the interests of its owners, the shareholders. The interests of the board and the shareholders ought to coincide, but in practice they may be at odds with each other. The challenge of good corporate governance is to find a way in which the interests of shareholders, directors and other stakeholders (interest groups) can all be sufficiently satisfied.

Corporate governance is a matter of much greater importance for large public companies, where the separation of ownership from management is much wider than for small private companies. Public companies raise capital on the stock markets, and institutional investors hold vast portfolios of shares and other investments. Investors need to know that their money is reasonably safe. Should there be any doubts about the integrity or intentions of the individuals in charge of a company, the value of the company’s shares will be affected and the company will have difficulty raising any new capital should it wish to do so. If there is weak corporate governance in a country generally, the country will struggle to attract foreign investment.

It might seem self-evident that good (or adequate) corporate governance supports capital markets. However, the impetus for the development of codes of best practice and stricter regulatory regimes has come largely from scandals and setbacks, where evidence of bad corporate governance has emerged, and company share prices and the stock market generally have suffered as a consequence.

For two illustrative examples see the next page.
Answer to Question 8

The main reasons why corporate governance has become a matter of some interest in many countries are:

- Much of the pressure has come from *institutional investors*, particularly in the US, who have invested heavily in companies in other countries. As shareholders in foreign countries, US investors expect to be allowed to exercise their right to vote and to be treated on an equal footing with other equity shareholders. In countries where minority shareholder rights are not always well respected, US investor influence has probably been influential in the corporate governance changes that have happened.

- In many developing countries, there have been substantial investments in recent years by *multinational companies*, such as international banks. It might be expected that US and UK multinationals would establish a system of corporate governance within their subsidiaries along similar lines to the parent company, for example, with non-executive directors on the board representing interest groups in the local country. Some multinational companies have become increasingly aware of their reputation in markets in other countries, and alert to the demands of pressure groups as well as governments in the countries where they have operating subsidiaries.

- Apart from multinationals, the largest commercial organisations in many developing countries are *government-owned* or *government-controlled*. Government-controlled organisations are not necessarily operated on fully commercial lines and some board membership may reflect political interests within the country. Where the government is heavily involved in commercial interests, such as water provision, electricity provision, transport, road building, and so on, it should be expected that it will be influential in bringing about improvements in corporate governance.
Answer to Question 9
Investors interact with the company and monitor manager activities in different ways:

1. **Auditors**, acting on behalf of shareholders, examine the company’s accounting systems and comment on whether financial statements fairly represent the financial position of the company. Investors and other stakeholders use the public financial statements to make decisions about the company’s financial health, prospects, performance, and value. Even though investors may not have the ability or opportunity to validate the company’s activities, accountants and auditors can attest to the company’s health and verify its activities.

2. **Investment analysts** who follow a company conduct their own, independent evaluations of the company’s business activities and report their findings to the investment community. Analysts are supposed to give unbiased and expert assessments.

3. **Investment banks** also interact with management by helping companies access the capital markets. When obtaining more capital from public investors, companies must register documents (such as prospectuses) with regulators that show potential investors the condition of the company. Investment banks help companies with this process and advise managers on how to interact with capital markets.

4. The **government** also monitors business activities through the US Securities and Exchange Commission (SEC). In the UK the same process was previously undertaken by the Financial Services Authority, however with effect from 1 April 2013 (by the Finance Service Act 2012) the FSA was abolished and its responsibilities were split between the **Prudential Regulation Authority** and the **Financial Conduct Authority**. In both countries, and in similar public bodies in countries throughout the world, such activities regulate public companies for the protection of public investors.

As a group, this is an impressive set of monitors. Unfortunately, all of these mechanisms can fail at one time or another which again places emphasis on the need for **strong corporate governance**.

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Answer to Question 10
During this period the number of new companies that needed auditing services was no longer expanding. If auditing firms wanted to grow, they had to steal clients away from other auditing firms. The code of ethics was changed to permit advertising and other competitive practices. Auditing firms began to advertise and cut their prices to lure new clients. The relationship between the auditing firm and the management of the audited company also began to change; with other audit firms courting them, corporate managers no longer tolerated adversarial auditors. Auditors became friendlier in order to keep their clients, especially the larger companies. During this period, auditing firms also developed consulting services to advise companies on how to improve their accounting methods and business activities. This provided both another source of income for accounting firms and a way to solidify their relationships with company management.

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Answer to Question 11
During the past two to three decades the role of accounting departments within companies has changed. Instead of just providing information to insiders and outsiders, accounting departments have begun to transition into being profit centres. Instead of simply reporting the quarterly profits of the company, accounting departments are being asked to increase profits through application of accounting methods. In some areas the ambiguity in GAAP and the **subjectivity** of business activities provide for different ways of accounting for the same transaction. Different methods often lead to different levels of reportable profits.

One example of variations in accounting method applications relates to the desire of companies to exhibit a **steady growth in profits**. If the profits generated by business activities grow, but at an erratic pace, then accountants are asked to smooth out the earnings over time. This process is referred to as **managing earnings**. (For examples of managing earnings see the next page.)
Examples of managing earnings:

1. A financing company can reduce its current earnings by being pessimistic in its estimates of losses from problem loans. If these loans eventually are repaid, future profits will increase. The manoeuvre effectively shifts some earnings into the future.

2. If a company is in need of more earnings in the present, it can conduct a property sale and leaseback. The transaction could work like this. The company sells a property with a book value of $50 million to a finance company or other investors for $100 million (which is the market value). The company signs a long-term lease with the investors so that it still uses the property. However, because the property has been depreciated to $50 million, the company can claim the difference as a capital gain and increase pre-tax profits by $50 million. Alternatively, the profit could be amortised over the life of the lease. Due to GAAP ambiguities and loopholes, companies can choose the methods that benefit them the most.

3. A company could sell an asset, such as a truck, to its own subsidiary (for example, technically a special-purpose entity created as an off-shore partnership) for an outrageously high price. The book value of the truck is low. Therefore, the company books a large capital gain and profits go up. The subsidiary capitalises the cost of the truck, which means that the subsidiary will have to report lower earnings in each of the future years in which the truck cost is depreciated. In effect, the company takes a profit now that it will have to offset as expenses in the future related to the sale of a truck it still owns!

While these types of manoeuvres help to manage earnings, their effect is limited unless the company crosses the line and uses them fraudulently.

Answer to Question 12
Business consulting firms typically advise companies on tactical issues, such as how to enter a new market, and strategic issues, such as acquiring or spinning of other firms.

One potential problem for a company’s shareholders occurs when a consulting firm also conducts auditing services for the company. The income for conducting an audit is far lower than the fees earned for consulting. Therefore, auditors may be pressured by their own accounting firm to overlook borderline practices, especially when consultants advocate those practices. The situation represents a serious conflict of interest for the auditors. Their responsibility should be effective monitoring for the shareholders but instead their inclination may be different because their bonuses depend on how much money the consulting group earns for the group.

(Note the US ‘Public Company Accounting Reform and Investor Protection Act 2002’ which is intended to separate auditors and consultants, prohibits accounting firms from providing both auditing and consulting activities to the same company. However such legislation does not exist in all countries, such as in UK where auditing and non-audit work are not legally separated.)

Answer to Question 13
A stakeholder group is an identifiable group of individuals or organisations with a vested interest. Stakeholder groups in a company include the shareholders, the directors, senior executive management and other employees, customers, suppliers, the general public and (in the case of many companies) the government. The nature of their interests differs between stakeholder groups. Issues in corporate governance are which stakeholder group interests should predominate and to what extent can the interests of different groups be met or reconciled.
Answer to Question 14
A person or entity that owns more than 50% of a company's outstanding shares. The majority shareholder is often the founder of the company, or in the case of long-established businesses, the founder's descendants. By virtue of controlling more than half of the voting interests in the company, the majority shareholder has a very significant influence in the business operations and strategic direction of the company. For example, the majority shareholder has the voting power to remove directors from the board, and so can control the board.

Majority shareholders differ in their approach to how the company is managed. While some continue to be heavily involved in the daily operations of the company, others may prefer to take a hands-off approach and leave the management of the company to the executives and managers.

Majority shareholders who wish to exit their business, or dilute their position, may make overtures to their competition or private equity firms, with the objective of getting a good price for their stake. Since the majority shareholder usually has an iron grip on the fortunes of the company, a hostile bid for it is generally out of the question.

Answer to Question 15
A minority share holder describes a situation where a significant but non-controlling ownership of less than 50% of a company's voting shares is owned by either an investor or another company.

When looked at as a category of stakeholder, minority shareholders are a group of shareholders whose combined shareholdings are insufficient to affect resolutions by the company in general meeting. The term is often used when a majority of shareholders (and possibly a single majority shareholder) favours one course of action while a minority opposes it. Company law provides some safeguards for minority shareholders, to protect them from unfair or discriminatory actions by the majority.

Answer to Question 16
An executive director is a working director of an organisation who is usually also its full-time employee, and has a specified decision making role as director of finance, marketing, operations, etc., on an ongoing basis. The executive director is responsible for the day-to-day management of the organisation, working with the Board of Directors, and operating within a budget.

The standard of care required from executive directors is higher than that required from non-executive directors. In US, and other countries, an executive director is also called inside director or internal director (US).

Answer to Question 17
An institutional investor is an organisation or institution that invests funds of clients, savers or depositors. The main institutional investors are pension funds, insurance/life assurance companies, investment trust companies and organisations such as unit trusts and open-end investment companies (‘OEICs’). Institutional investors are the main investors in shares in the leading stock markets of the world. In the UK, most institutional investors are members of an 'industry association', such as the Association of British Insurers and the National Association of Pension Funds. These make best practice recommendations to their members.
Companies in most countries have ‘unitary boards’, in other words, just one board of directors accountable to the shareholders. The origins of the unitary board lie in the seventeenth century.

The unitary board relies on a single-tiered Board of Directors that is normally equally balanced with executive and non-executive directors elected by shareholders. Because of this, it is also known as “the unitary system”.

The Unitary system includes the use of board committees who report to the main board.

A typical unitary board structure is shown below.
Another approach to corporate governance is to have **two-tier boards**. A two-tier structure is used in some countries, such as Germany, France and the Netherlands.

With a two-tier structure, there is a **supervisory board** and a **management board**.

1. In a two-tier structure, there has to be a functional relationship between the management board and the supervisory board, and the chairman of the supervisory board plays a key role.
2. The chairman of the supervisory board is responsible for making sure that the two boards work well together, and the most powerful individuals in the company are the chairman of the supervisory board and the chief executive officer who is in charge of the management board.
3. The chief executive officer reports to the supervisory board chairman.
4. If the relationship between these two individuals works well, the chairman will effectively speak for the management at meetings of the supervisory board.
5. The management board consists entirely of executive directors. The supervisory board consists entirely of non-executive directors.
1. In Germany, which has been described as the ‘apostle of the stakeholder principle’, supervisory board members include:
   - representatives of trade unions and/or the company’s employees,
   - representatives of a major shareholder, such as one of the German banks (who have extensive shareholdings in German companies),
   - former executives of the company.

2. The supervisory board non-executive directors are therefore not necessarily independent, particularly employee representatives. It can therefore be difficult to reconcile the differing views of employee representatives and representatives of major shareholders, without antagonising the executives on the management board.

3. On the other hand, where there is a large number of former executives on the supervisory board, there is a risk that the supervisor board could take a lenient and easy-going view of what management are doing.

4. In addition, some independent supervisory board directors might well be senior managers of other companies where they are management board members. These individuals might therefore sympathise with the views of management.

---

In ev'ry job that must be done
There is an element of fun
You find the fun and snap!
The job's a game

Nad ev'ry task you undertake
Becomes a piece of cake
A lark! Aspree!
It's very clear to me

That a...
Spoonful of sugar helps the medicine go down
The medicine go down-wown
The medicine go down
Just a spoonful of sugar helps the medicine go down
In a most delightful way

A Spoonful of Sugar
Mary Poppins
Some companies use a board committee of non-executive directors which consist of directors who are not managers, employees or former officers of the company or any of its subsidiaries.

The key role of the Committee of Non-Executive Directors is to review and evaluate the performance of the chief executive officer of the company and to help establish individual and corporate goals and strategies relating to the corporation's chief executive officer.

The Committee of Non-Executive Directors should meet at least twice during each calendar year, often after the main board meeting has finished, under the leadership of one of its members.

The Committee of Non-Executives also reviews other matters as it, in its discretion, considers appropriate, including but not limited to the performance and processes of the Board of Directors and the flow of information to and from the Board of Directors, the company's management, and the company's. The Committee shall make recommendations, if appropriate, to the Board of Directors with respect to matters considered by the Committee.

The Committee of Executive Directors, when used, is set up as a board subcommittee which has well defined executive powers and which meets frequently to manage the affairs and further the purposes of a company or entity. This committee is particularly appropriate where a company has a large Board of Directors such as a large multinational company (with millions of shareholders).

For organisations where the Board of Directors is large - say 20 people or more – and it is difficult to set up full board meetings quickly, it is common to have an Executive Committee of the Board—an executive subcommittee of Board members, which is authorised to make some decisions on behalf of the entire Board.
Advantages of unitary boards – 6 of 9

- **Common legal responsibility**
  All participants in the single board have legal responsibility for management of the company and strategic performance. This implies a more active approach by those directors who are not executive directors and therefore act in an independent and ‘supervisory’ capacity.

- **Maintenance of better relationships**
  The relationship between different types of directors may be better as a single board promotes easier cooperation.

- **Questioning**
  The presence of non-executive directors with different viewpoints to question the actions and decisions of executive directors as they are taking place should lead to better decisions being made.

- **Inclusion in decision-making**
  If all the directors attend the same meetings, the independent directors are less likely to be excluded from decision-making and given restricted access to information. Boards that take all views into account in decision-making may end up making better decisions.
Disadvantages of unitary boards – 7 of 9

The unitary board emphasises the divide between the shareholders and the directors.

Shareholder representatives cannot be included on the board other than as directors.

Non-executive directors’ primary role is to monitor decision-making by executive directors. They may find it very difficult to monitor objectively if they are also significantly involved in decision-making themselves.

In some jurisdictions, for example the UK, the unitary board can be seen as emphasising a division between directors and employees who are not represented on the board.

The time requirements on non-executives may be onerous, both in terms of the time spent in board meetings and the commitment required to obtain sufficient knowledge about the company to properly fulfil their monitoring role.

Objectivity of monitoring

Time requirements

Disadvantages of unitary boards

Entrenchment of division between board and employees

Relationships with shareholders

The time requirements on non-executives may be onerous, both in terms of the time spent in board meetings and the commitment required to obtain sufficient knowledge about the company to properly fulfil their monitoring role.

Non-executive directors’ primary role is to monitor decision-making by executive directors. They may find it very difficult to monitor objectively if they are also significantly involved in decision-making themselves.

In some jurisdictions, for example the UK, the unitary board can be seen as emphasising a division between directors and employees who are not represented on the board.
The main argument in favour of two-tier boards is the *clear and formal separation* between the monitors and the executive directors being monitored.

The supervisory/policy board has the *capacity* to be an *effective guard* against management inefficiency or worse. Indeed its very existence may be a *deterrent* to fraud or irregularity in a similar way to the independent audit.

The supervisory/policy board should take *account of the needs of stakeholders* other than shareholders, specifically *employees* who are clearly important stakeholders in practice. The system actively *encourages transparency within the company*, between the boards and, through the supervisory board, to the employees and the stakeholders. It also involves the shareholders and employees in the supervision and appointment of directors.

If the split of the board is on strategic/operational lines, a small strategic board may be able to act more *quickly and decisively* than a larger board that includes everyone with operational responsibilities.

The supervisory/policy board has the capacity to be an effective guard against management inefficiency or worse. Indeed its very existence may be a deterrent to fraud or irregularity in a similar way to the independent audit.
Disadvantages of two-tier boards – 9 of 9

Exclusion of board members, particularly those with operational responsibilities from important strategic discussions, may result in decisions that do not take full account of all the important factors. Directors who are not consulted may not support the decisions, particularly if they regard them as **unworkable**.

- **Lack of clarity**
- **Limitations of strategic board**
- **Disadvantages of unitary boards**
- **Ineffectiveness of supervisory board**
- **Lack of independence**

Confusion over authority and therefore a **lack of accountability** can arise with multi-tier boards. This criticism has been particularly levelled at companies where the consequence is allegedly often over-secretive procedures.

In practice, the supervisory/policy board may not be as effective as it seems in theory. The **executive management board may restrict the information passed on** to the supervisory board and the boards may only liaise infrequently.

The supervisory board may not be as **independent** as would be wished, depending on how rigorous the appointment procedures are. In addition, members of the supervisory board can be, indeed are likely to be, shareholder representatives. This could detract from legal requirements that shareholders don’t instruct executive directors how to manage if the supervisory board was particularly strong.
Glossary of Terms
(Note: Many of these terms are also hyperlinked from the questions and answers.)

ACCA Paper P1: Governance, Risk and Ethics

You can also scroll page-by-page or 'word-search'
<table>
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<th><strong>Glossary of terms - A</strong></th>
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**Aberrant behaviour**  
Differing from the normal or accepted way

**Accountability**  
The obligation of an individual or organisation to account for its activities, accept responsibility for them, and to disclose the results in a transparent manner. It also includes the responsibility for money or other entrusted property.

**Acquisitive company**  
A company tending or seeking to acquire and own other companies.

**Adage**  
A proverb or short statement expressing a general truth.

**Ad-hoc situation**  
An improvised situation. To bring about suddenly.

**Administration**  
A company in administration is operated by an external independent administrator (as interim chief executive) on behalf of the creditors as a **going concern** while options are sought short of liquidation. These options include recapitalising the business, selling the business to new owners, or demerging it into elements that can be sold and closing the remainder.

**Amortisation**  
The practice of reducing the value of assets to reflect their reduced worth over time. The term means the same as depreciation, though in practice amortisation tends to be used for the write-off of intangible assets, such as goodwill, while either term is used for the write-off of fixed capital. Amortising an asset effectively transfers its value, or the part that is being written off, from the balance sheet to the profit and loss account, where it reduces taxable income. (Amortisation of discounts relates to a situation where a bond is issued at a discount - that is, offered for sale below its par (face value) and where the discount must be treated either as an expense or can be amortised as an asset. Amortising allows bond issuers to treat the bond discount as an asset over the life of the bond [until the bond's maturity]).

**Aphoristic**  
A tersely phrased statement of a truth or opinion; an **adage** (see this page).

**Appropriateness (of information)**  
The measure of the quality of information; that is, its relevance and its reliability in providing support for the conclusions on which the manager’s decision is based.

**Arms length**  
The **arm's length principle** is the condition or the fact that the parties to a transaction are independent and on an equal footing. Such a transaction is known as an "arm's-length transaction".

**Articles of association**  
In corporate governance, a company's **articles of association** (called articles of incorporation in some jurisdictions) is a document which, along with the **memorandum of association** (in cases where the memorandum exists) form the company's constitution, defines the responsibilities of the directors, the kind of business to be undertaken, and the means by which the shareholders exert control over the board of directors.
THE END PAGE

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