London
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& Finance

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InterActive

ACCA Paper P1

Governance, Risk & Ethics

Class Notes

Dec. 2014

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Introduction to the paper

AIM OF THE PAPER

The aim of the paper is to apply relevant knowledge, skills and exercise professional judgement in carrying out the role of the accountant relating to governance, internal control, compliance and the management of risk within an organisation – in the context of an overall ethical framework.

OUTLINE OF THE SYLLABUS

1. Governance and responsibility.
2. Internal control and review.
3. Identifying, assessing and controlling risk.
4. Professional values and ethics

FORMAT OF THE EXAM PAPER

The syllabus is assessed by a three hour paper-based examination.

The examination consists of:

- one 50 mark compulsory case study
- two from three 25 mark scenarios.

FAQs

How do I get the most from my course?

- Try and be seated by the start of the lecture. This will ensure we have the maximum lecture time. Your course notes will be divided into chapters, please make sure you bring the relevant chapters with you to class.
- Manage your time effectively. If you have a busy work schedule use your study planner to catch up. Do not allow yourself to fall behind.
- Should you have any difficulties or questions please do not hesitate to contact me either before the lecture or during the break as most students are in a desperate hurry to leave at the end of the lecture. Alternatively, you can always email me or phone me through our helpline.
- In the event of an emergency you can come for the same lecture on a corresponding part-time course as all the courses run parallel to each other. It is crucially important that you attend the full course of lectures.
- Try to read the business section of a decent newspaper at least once a week to get an idea of what is going on in the business world and the difficulties faced by organisations.

Chapter 1

Theories of corporate governance

ACCA STUDY GUIDE REFERENCES

- Define and explain the meaning of corporate governance
- Explain and analyse the issues raised by the development of the joint stock company as the dominant form of business organisation
- Analyse the purposes and objectives of corporate governance
- Explain and apply in the context of corporate governance, the key underpinning concepts of fairness, integrity etc
- Explain the major areas of organisational life affected by issues in corporate governance
- Define and explore agency theory
- Define and explain key concepts in agency theory
- Explore the agency relationship
- Explain and analyse transaction cost theory
- Explain and analyse stakeholder theory

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INTRODUCTION

Interest in the way in which corporations are managed is increasing. It is the hot topic of the day. Global Institutions such as the Organisation for Economic Cooperation and Development (OECD) offer advice to governments with regard to corporate regulation. Governments attempt to develop and constrain corporations in the interests of their citizens. Corporations are mindful of the need to regulate themselves, to promote success and avoid scandal. Society demands the products that corporations produce whilst being concerned over the impact of unregulated activity on their communities and the planet as a whole.

This widespread interest derives from the increasing status of the corporation as the central player in the way in which society operates. Corporations generate the products and the wealth that support or facilitate our way of life. They are the heart of the capitalist model.

This status as a central actor in society has not always existed. It is only in recent history that the concept of a body managed by one party on behalf of separate, private citizens, virtually divorced from state control, with a scale to reach beyond a single state's borders, has existed and therefore needs to be considered by society and a relationship with that entity defined and managed.

The nature of that relationship, the strengths and opportunities arising from it, balanced against the faults within it and the threats that derive from it, defines and redefines the nature of societies within which our lives take place. It affects us every day and will increasingly do so into the future. The curtain opener to this century, the credit crunch, warns us that without due consideration of the governance of this relationship, lives may be ruined and nations fall.

It is therefore difficult to understate the significance of corporate governance as a topic for consideration by each member of society, but particularly by those who operate deep within the corporation and the capitalist system. Through an understanding of the governance relationships that exist, accountants can better position themselves to provide advice as to how the organisation should be managed for the benefit of shareholders, the markets and society as a whole.

Definition and meaning of corporate governance

Governance can be viewed as the management of the organisation, distinguished from the general need to organise and support company activity by the strategic nature of the concept of governing or controlling at the highest level.

A dictionary definition confirms the root of the Governance to be the Latin word "Gubernare", meaning "to steer". This suggests that governance is about commanding the direction of the vessel as it ploughs the seas of trade. This direction will be provided by the board of directors and so governance relates to the actions of directors and the decisions that they reach.

It is also true that governance is perceived as the actions of government in determining how others operate in society. In this sense governance relates to regulation of the nature of external control over corporate activity.

These two ideas are usefully drawn together in a formal definition by the father of UK governance, Adrian Cadbury 1992:

"Governance is the system by which companies are directed and controlled"

This definition can be expanded in order to give a sense of the focus and importance of such activity.

"Governance is the system by which companies are directed and controlled in the interest of shareholders and other stakeholders"

By defining the need for decisions to be made in the interest of shareholders, the board recognises their legal duty in the way in which the company operates. By recognising the importance of stakeholders the company promotes the need for a positive relationship to be established. Such a relationship can lead to:

- Improved sales
- Reduced opposition to corporate activity
- Less regulation of corporations
- Improved profits
- Improved investment

amongst many other gains.

If governance is viewed as having two dimensions, direction and control, then these can be used as a way of determining the scope of governance and through this to give a deeper sense of its meaning and application.

1. Direction

The provision of direction to organisational activity is an internal issue determined by the actions of the board of directors.

- The need to define roles and responsibilities of the board of directors and top tier management.
- The need to determine policy, practice and programs through which to act.
- The need to determine threat and respond to this through appropriate mechanisms of internal control.

2. Control

The exaction of control over the corporation is an external activity determined by the actions of government and regulators.

- The need to pass legislation to provide a framework for operations.
- The need to determine rules of corporate activity through regulation of stock exchanges.
- The need to engage in dialogue with stakeholders, to listen and respond to their concerns.

Development of the joint stock company

The development of the joint stock corporation as a syllabus reference is a device used to promote two concepts, firstly that society's relationship with the corporation has developed over long periods of time and secondly that this development is truly an evolution that highlights the growing nature of power that corporations wield.

In 2003, Burnett and Games in their text "Who really runs the world?" suggest a tipping point in history during that year that prompted them to commit the moment to the written word. They suggest that, during that year, when the top 100 economic powers of the world are identified, for the first time in history the percentage relating to corporations, rather than governments, had passed into the majority of 51%.

Whilst any democratic society would insist on the accountability to society of those that command power (indeed wars are often fought over this), it seems that the passing of majority power on the planet to an almost totally unaccountable body of institutions has taken place almost without recognition. Governance and governance regulation seeks to address this issue, in making those who have power take responsibility and account for their actions.

In order to examine this issue any reasonable time frame could be used. The following offers some insight into the evolution of the corporation without wishing to suggest that this topic is anything other than scene setting to examining the nature of governance requirement.

1600s

The creation of the first major, independent institutions, incorporated under royal charter or agreement, to carry out specific and restricted activities which the crown is either unwilling or unable to perform with its own finances. In the UK the creation of the East India Company is an example of such an institution. At its incorporation it was given the sole trading rights between England and those lands east of India. The success of this corporation became the basis for the growth of Empire and the positioning of England as a global power through the subsequent centuries.

In this sense the corporation can be viewed as an entity that works with society for the benefit of both.

1700s

The success of the East India Company led directly to the establishment of the London Stock Exchange in the early years of this century. The promise of wealth creation through the purchase of a share and the holding of that stock with others in support of a business enterprise was a new idea and one that attracted virtually all of the moneyed classes in the UK and Europe.

Such was the success of the idea that new corporations such as the South Seas Company, promising wealth through exploration of the other side of the globe, attracted huge sums of investment. It was easy to see how frenzied public demand for shares and a total lack of regulation over the nature of promises and information supplied by directors coupled with governmental complicity in allowing unfettered share trading had the potential for a short term boom in the summer of 1720 prior to the inevitable loss of confidence and stock exchange crash.

The scale of the losses by the wealthiest members of society and the virtual bankrupting of the country subsequently led to the exchange being shut and corporations being effectively banned for more than one hundred years.

1800s

Industrialisation and innovation during the 19th century led to the creation of large production facilities and the need to build national infrastructure to bring the goods produced in these factories to market. Such infrastructure, particularly in the US was beyond the means of the government to finance, and so corporations were created and allowed to raise funds through share offerings to fill the need and finance these construction projects.

In order to attract investment Limited Liability was established and, later, separate legal identity created to provide a governance structure to support corporations. The UK followed suit in 1855 with the Limited Liability Act and Salomon v Salomon in 1897, in part to stop the outflow of finance to the US where this improved regulation already provided the right conditions for secure investment.

In this sense, Governance is about governments balancing the needs of corporations and the needs of society or providing the appropriate degree of regulation to enable corporations and, through them, the country to grow.

1900s

The Wall Street Crash of October 1929 and the subsequent Great Depression demonstrates how governance undone can destroy societies. The lead up to the crash saw the usual suspects of:

- Over confidence of investors without foundation in corporate performance.
- Lack of factual accounting information concerning corporate performance.
- Insider trading and market manipulation by those in a position to affect the market.
- Naive investors following poor and partisan advice of "experts".
- Excessive risk taking.
- Lack of internal control, audit and accounting.
- Rapid unsustainable economic growth.

The subsequent crash led a global generation into bankruptcy.

In 1932 Bearle and Means, looking back on the events that had defined their lives in the markets, reluctantly reporting that the lessons had not been learnt.

Shareholders of large corporations were too separate from the directors who managed their investment. Worse, shareholders had little interest in how corporations were run and were much more likely to simply sell their shares if returns did not match expectation rather than criticise or become involved in dialogue with directors. The separation of ownership and control was identified for the first time.

WWII and its aftermath saw the rise of the global corporation and the increasing distancing of those that owned the organisation from those that ran it at a time when the scope of operations meant that such institutions had increasing great potential to affect not just the markets and shareholders but all of those with whom they interact, from communities to government.

At the turn of the century, Burnett and Games preside over a situation that has never occurred in all history, and those with an interest in governance are faced with challenges that have simply never been faced before.

The cost of not facing or dealing with those challenges must be considered with regard to the immense potential corporations now have to support or threaten societies.

Purpose and objectives of governance

The historical rise of corporations and the scope of their impact suggest that the objective of governance should be simply one of constraining excessive behaviour through legislation. However, the straitjacket this would create through over-regulation may choke off the ability of corporations to operate successfully or may see investors' dollars fleeing the country for less regulated (and potentially more successful) markets.

The objectives of governance could therefore be seen as the need to both facilitate and control, the purpose is to support the system of wealth creation of capitalism.

Objectives will differ dependent on whose interests are being considered.

- Board of Directors
    - To identify the rules of the game within which the company should operate to sustain listing on the exchange.
    - To provide advice or guidance regarding best practice methods of managing the enterprise.
    - To attract investment.
- Shareholders
    - To create a safe environment within which they can invest.
    - To improve global investment opportunities.
    - To improve accountability and responsibility.
- Governments
    - To provide a legal framework within which accountability can be exacted.
    - To create conditions for growth and employment.
    - To attract global investment and support the economy and society.

Any specific objective will depend not just on the stakeholder perspective but also will tend to change over time. In 2012, the illegal activities of UK banks suggested that governance should be used as a mechanism to facilitate societal retribution through the courts as well as a mechanism to redefine the banks' role in society.

SCOPE OF GOVERNANCE

The multiplicity of perspectives through which governance objectives can be determined suggests that the scope of governance could be vast. Since governance is defined as being a question of direction and control then the scope of governance can be viewed through these separate lenses:

1. Direction

This is an internal perspective, looking at the scope of governance activity created by and enacted through the board of directors.

The scope of governance would include:

- Defining corporate structure and roles.
- Ensuring an appropriate professional culture exists within the company.
- Establishing programs, policies, procedures and rules for internal control.
- Monitoring and adapting as necessary to ensure objectives are met.

2. Control

This is an external perspective, looking at the scope of governance activity imposed on the board of directors from outside.

The scope of governance would include:

- All forms of legislation including corporate law, health and safety and employee legislation.
- The imposition of stock exchange regulation.
- Accounting and audit standards.

The sense of direction suggests the need for underlying belief systems to be in place so that the board of directors understands how it should act. The sense of control prompts the need to identify the scope of governance that is common in the regulation of stock exchanges.

Underlying principles of governance

These principles must underlie the belief systems and decisions of the board of directors. Without their existence or if their existence is called into question it is likely to affect the willingness of shareholders to invest and may lead to governmental action to force the corporation to move in line with the types of behaviour expected from it by society.

1. Fairness

A sense of balance or even handedness when dealing with others.

This is particularly true in stakeholder relationships. What is defined as being fair is intangible however it relates to a societal perception of what are expected norms of behaviour and a sense of fairness between differing groups such as the fairness of directors pay in relation to that received by employees.

2. Openness/ Transparency

A sense of lifting the veil over operations.

The ability of stakeholders and shareholders to easily see through decisions operations to their core.

Transparency can relate to the communication of financial position and the identification of investment or corporate risk. Transparency is assisted through disclosure of decision rationale and the use of regular meetings with shareholders.

3. Independence

The ability to be separate from personal or other influence outside of that prescribed through your formal role in the organisation.

Independence is as much an issue for directors as it is for auditors. Independence requires a sense of detachment and relates to the need for clarity in terms of what an individuals' role should be.

4. Probity / Honesty

Abiding by the legal standards that exist in society.

It also suggests a more general sense of being an honest player or an individual with high ethics. It may be said that honesty has a tangible interpretation relating to adhering to the law whereas a sense of probity is a sense of fair dealing or honesty in a less defined societal sense.

5. Responsibility

This relates to the need to accept liability for ones actions.

The willingness not to hide behind blame placed on others but rather to accept ones' own involvement in the actions of the corporation. A sense of responsibility could be viewed in a limited scope with regard to shareholders needs but should be viewed in a wider sense of responsibility to country or society as a whole.

6. Accountability

This is a development of responsibility.

Here the sense of accepting liability for our actions is extended to include the need to demonstrate this sense of responsibility through the communication of actions taken or decisions reached to interested bodies. Accountability can be seen within the accounts provided to the market or in the wider nature of disclosure. Directors may also account through the Annual General Meeting or even in representation at a parliamentary enquiry.

7. Integrity

A building's integrity relates to its strength or solidity.

An individual can demonstrate integrity through operating to a high moral code of ethics. This integrity must withstand the influences of self-interest or the pressure placed upon an individual by others to act in a way that would compromise the integrity of the director.

8. Judgement

This relates to the ability to weigh issues, to have balance or to not be swayed by emotive issues.

Judgement is supported through information or a formal process of deliberation. Demonstrating good judgement could be through examination of the performance of the company although in an ethical sense good judgement requires consideration of fairness and integrity rather than simply viewing the bottom line.

9. Reputation

Reputation is an outcome of demonstrating adequate adherence to the other underlying principles. Reputation may be viewed from an individual or entire board or corporate perspective. If reputation of the individual is called into question their position on the board becomes insecure. If the company's reputation is questioned this can have a long term damaging effect on profits.

Practical scope of governance

The practical scope of governance will embrace both the legislative and exchange led regulation that exists in a given market. This is unique to each country or market place. However, the following, drawn from the UK Corporate Governance Code, gives a sense of the practical scope and depth.

1. The board of directors

An effective board of directors should:

- Lead company strategy, with prudent controls and risk management, to maximise sustainable long term success of company.
- Set the company's values.
- Should meet regularly, with a formal agenda.
- Should detail its membership (including Chairman, CEO, Senior Independent Director, Committee members) and work in the Annual Report.
- Should ensure Chairman and Non Executive Directors (NEDs) meet without the Executives, to consider their performance.
- Should ensure NEDs meet without Chairman annually, to consider the performance of the Chairman.

2. Chairman and Chief Executive Officer

Issues that relate to the Chairman and CEO:

- Should not be the same person.
- Chairman leads Board, and sets agenda for Board Meetings ensuring there is enough time for important matters and all directors contribute.
- Chairman is key contact for shareholders.
- CEO runs the company.

3. Board composition

- No one person, or group, should be able to dominate the Board.
- Should be an appropriate size, and right balance of skills and experience. This includes diversity, including by gender.

4. Appointments to the board

- Have objective merit-based criteria for selection of new Board members.
- Oversee induction and training for all directors (likely to be organised by Chairman, assisted by Company Secretary).

5. Annual performance review

- Board, its committees, and individual directors should have performance appraised at least annually.

6. Re-election of board members

- At 1st AGM after appointment to Board, and at least every 3 years afterwards, by shareholders (note, for FTSE 350 companies, all directors are up for re-election every year).
- If not annual re-election for all directors, sensible to "retire by rotation" and avoid potentially losing all the Board in one go.

7. Remuneration of directors

- Significant proportion should be performance-related.
- Should consider industry pay levels.
- Enough to attract, retain and motivate.
- Notice periods no longer than 1 year.

8. Internal control

- Board should ensure a sound system of Controls.
- Annual review of effectiveness of Controls, and report this in Annual Report.
- Audit Committee of at least 3 Independent NEDs.
- Main role is liaison with the internal and external auditors on all matters.

9. Relations with shareholders

- Regular dialogue with shareholders.
- Chairman to ensure shareholder views communicated to Board.
- Communicate with investors and encourage debate through AGM.
- Separate resolutions on each issue.

10. Institutional shareholders (UK Stewardship Code)

- Should themselves ensure dialogue with directors.
- Should make considered use of their considerable voting power.

Exercise 1 Union Chloride

Union Chloride Inc. (UCI) is a listed multinational chemical company. Last year, in a major departure from its core activities, the board of directors informed shareholders that it intended to build a golf course.

More specifically, at the insistence of the CEO and Chairman, Arthur Nail, the course was to be built on Mr Nail's country estate. Mr Nail explained to the board that the golf course would reap major benefits in terms of entertaining company clients. In addition, Mr Nail, as a multi-millionaire in his own right, intended to sponsor a golf competition on the course each year open to professional players and celebrity / political guests. This, he suggested, would attract media coverage and improve the company's public relations.

The board of directors, consisting of old friends and acquaintances of Mr Nail, agreed unanimously and issued a press statement immediately detailing how the estimated $50 million would be spent.

The news was not received well by shareholders. They demanded more information on exactly how the investment would return a profit to them. Key media TV channels said they were unlikely to air any sporting events at the venue. Further, in order to pass through planning permission, Mr Nail promised the course would be open to the public. Since construction has started Mr Nail says that he does not recollect having made any such promise. As a result the local state legislature is considering legal action to stop the development continuing.

Costs of the project are escalating, especially since Mr Nail's insistence on building a major leisure complex next to the course for his personal use. The audit committee, created at the insistence of the shareholders and populated by board members, states they have received assurances from Mr Nail that the project is under control although they have very little financial information regarding progress.

The board of directors refuse to comment on the project as individuals, leaving any press releases to Mr Nail. The board's average age is 75 and Mr Nail himself is in his mid-nineties. It has been company policy to award Mr Nail with an annual bonus of $1million each year following his ninetieth birthday in celebration of his continued association with the company. Unusually any, rumours of a decline in Mr Nail's heath are met with a sharp rise in share price.

Required:

(a) Identify governance issues that affect UCI.

(b) Consider the application of fundamental concepts of independence, fairness and transparency to this scenario.

Exercise 1: Union Chloride - notes for an answer

(a)

Governance issues that are of significance to this company include:

- The extent to which the directors are acting in shareholders' interests in terms of the strategy leading to any financial benefit.
- The unwillingness of the board to act on shareholders concerns.
- The inability of shareholder representatives (audit committee) to act in accordance with the shareholders wishes
- The lack of shareholder representation on the board through an independent chairman.
- The lack of individuality or independence of directors from the CEO/Chairman.
- The lack of internal control over the cost of the project.
- The lack of balance on the board of directors in terms of the nature of personnel.
- The extent to which Mr Nail's position is itself against the shareholders' interests.
- The impact of poor governance on key stakeholder relationships.
- The lack of fundamental principles such as honesty on the board.

(b)

Independence

- Lack of independence of Mr Nail's self-interest from his need to act on shareholders behalf.
- Lack of independence of the board from Mr Nail's views.
- Lack of independence of the audit committee.

Fairness

- Lack of fairness towards the shareholders in terms of the use of their money.
- Lack of fairness in relation to changing the basis for planning permission acceptance.
- Lack of fairness to the public in refusing them entry to the course.

Transparency

- Lack of transparency in provision of project cost data.
- General lack of transparency in board operations and influences over decision making.

SPECIFIC THEORIES OF GOVERNANCE

A theory could be considered to be something unreliable until it can be proven through practical application. However, once its truth has been witnessed and substantiated on many occasions the sense of what a theory is changes to being something that amounts to an unarguable truth that has application regardless of the conditions that exist or, in this instance, the jurisdiction that the organisation operates within.

The specific theories of governance should therefore be regarded as a foundation truth upon which the practical nature of regulation is built. It is also true that, as a foundation, if the requirements of the theory are not met, no amount of regulation heaped upon its broken rubble will withstand the harsh winds that continuously blow through the marketplaces of the world.

Agency theory

Agency theory describes the nature of the relationship that exists or should exist between the board of directors and the shareholders. It presupposes the existence of an active market through which shares are purchased and sold (joint stock corporation) and therefore the existence of a separation between those that own the company (shareholders) and the agents that manage the corporation on their behalf(the board of directors).

This is the separation of ownership and control

The existence of two parties in agency theory requires us to focus on the nature and strength of the relationship between them. The central issue is the requirement for trust to exist between the two parties.

In line with the scope of governance having both a theoretical and practical side, so the relationship exists at two levels. Most importantly the fundamental principles must feature in the actions of the directors to create a sense of trust. This sense of trust can then be enhanced further through the existence of regulation that forces the board to ensure it is carrying out its duties as expected by shareholders.

The root of the regulation is the legal requirement that:

"The directors must act in the best interests of shareholders"

This is a fiduciary obligation of the board of directors.

Agency costs

The need for directors to act in accordance with regulation is a price that the directors must accept and the shareholders must pay for in order to sustain the sense of trust.

These costs include:

- The cost of financial accounting for disclosure
- The cost of audit
- The cost of meetings and dialogue with shareholders

Such monitoring costs will not be enough to sustain the relationship since, in order to act in accordance with shareholder wishes, the directors own sense of self interest must be dealt with. The underlying principles existing in quality strategic

managers should be enough to ensure the directors' self-interest is not given precedent over shareholders' needs. However, by aligning that self-interest in a positive sense with the same objectives as shareholders (profit and reward) it is more certain that trust can be established and maintained.

There are three types of agency cost:

- **1. Monitoring costs (see above)**
- **2. Directors Remuneration**
- **2. Residual costs**

Agency costs always exist. The extent to which each category is important will depend on a number of issues.

1. Monitoring costs

These could depend on the level of regulation required by the stock exchange or government within which the company operates. Monitoring costs determined by shareholders will increase where perceived trust does not exist

2. Directors Remuneration

This includes directorial bonuses and share option schemes.

This will usually reflect the need to attract and retain high quality directors. It also depends on the ability of the director to influence this own remuneration package.

3. Residual costs

These are costs that arise out of the use of professional managers to represent your interests as shareholders.

They can be considered as benefits or the expected costs of agency / the trappings of office or simply perks. They include use of the company flat, car and private jet.

These will generally relate to the industry or social norms that exist for public company directors in a given country or jurisdiction.

Transaction cost theory

Transaction Cost Theory has a distinguished pedigree with regard to business strategy generally and management accounting specifically.

It is a framework through which strategic choices are assessed. In particular, it is used to consider outsourcing decisions where options exist to perform a business function using existing staff or transfer operations to a supplier facility, possibly on the other side of the world.

Transacting with the third party or making the decision and acting upon it requires consideration of:

- Search and information costs: to find potential suppliers.
- Bargaining and decision costs: the cost per unit of using that supplier.
- Policing and enforcement cost: the cost of quality control.

An evaluation that embraces these issues against the benefits of carrying out the trade form the basis for the decision using a transaction cost approach.

Within governance, as opposed to strategic decision making, transaction cost theory is an expansion to agency theory that evaluates, not the cost of transacting with a supplier, but rather the cost of transacting with the board of directors as a shareholder and the extent to which the shareholders should or do trust the board in the agency relationship.

The criteria for assessing the strength of the relationship are:

1. Frequency

The frequency of change that occurs within the organisation or is implicit within the market place itself.

Companies or markets in a state of constant change are inherently risky and lead to a reduction in the level of confidence that exists

2. Uncertainty

The level of market or industry risk that exists or is perceived to exist.

This suggests factors beyond the control of the corporation, yet the actions of the company may suggest that it is less affected by issues such as environmental risk in oil extraction because of the amount it has invested in this area over many years.

3. Asset specificity

The specific risks associated with the company's chosen strategy including concern over company structure, systems, suppliers and staff.

Two further concerns

In addition to the three above, there are two further concerns that impact on the extent to which trust exists:

1. Bounded Rationality

This relates to the composition and skills that exist on the board of directors to handle the three issues raised above.

2. Opportunism

Being opportunistic is the nature of corporations and essential to corporate success. Here it is considered problematic since the term questions the rationale behind the opportunistic behaviour and the extent to which it is driven by directorial self-interest or the true interests of shareholders.

If the transaction cost is found to be high when the above five issues are considered by shareholders, a variety of measures are available to reduce the cost or its impact:

- Meetings with the chairman
- AGM resolutions
- Voting against the board
- Demands for improved disclosure
- Divesting the shares.

Stakeholder theory

Agency theory highlights the need for directors to act in the interest of shareholders. Transaction Cost Theory reinforces this idea through examining of criteria used to assess the strength of the relationship.

Stakeholder theory states that relationships exist between all entities in society and that no entity acts in isolation. It identifies the relationships that exist beyond the traditional shareholder relationship and examines the nature and strength of these relationships.

Organisational relationships exist with regard to many stakeholder groups:

- Employees
- Customers
- Suppliers
- Governments
- Communities
- Environment and Ecology.

Agency and stakeholder theory have similar characteristics:

- They both examine relationships
- They both identify the importance of trust
- They both require fundamental principles to exist.

Although stakeholder obligations are often considered to be secondary to the needs of the market some sense of the existence and influence of stakeholders is essential because of the impact failure to consider these groups can have on company profit.

An understanding of the importance of shareholder consideration because of their influence on profits is termed Enlightened Self Interest.

PAST PAPER ANALYSIS

December 2012

2 (a) Define governance and discuss how good governance makes it more difficult for companies to fail. (7 marks)

June 2012

1 (e) Explain agency and stakeholder relationships. (7 marks)

December 2011

No direct question.

June 2011

2 (b) Explain the case for transparency in governance. (8 marks)

December 2010

No direct question.

June 2010

1 (c) Discuss agency relationships. (10 marks)

December 2009

3 (a) Explain integrity and its importance. (5 marks)

June 2009

1 (c) Analyse agency relationships. (4 marks)

December 2008

No direct question.

June 2008

1 (d) Analyse confidentiality and transparency in governance. (6 marks)

3 (a) Identify agency and failures in governance (12 marks)

December 2007

1 (a) Define transparency and evaluate its importance. (10 marks)

4 (c) Examine the fiduciary relationship. (7 marks)

June 2007

2 (d) Define objectivity. (5 marks)

3 (a) Examine agency costs and the problems. (7 marks)

(b) Assess integrity and its worth. (7 marks)

Chapter 2

The development of corporate governance

ACCA STUDY GUIDE REFERENCES

- Explain and explore the development of corporate governance codes
- Describe and critically evaluate the reasons behind the development and use of codes of governance

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THE HISTORY OF GOVERNANCE

Agency theory demonstrates the importance of creating a trusting relationship between the board of directors and shareholders. It highlights the importance of monitoring costs and within this the need for appropriate regulation to provide a infrastructure within which corporate operations can take place.

This regulation may embrace the need for legislation and certainly includes the need for stock exchange rules and requirements that have application to any organisation seeking listing in order to attract investment.

The development of a fully formed stock exchange regulatory system is an incremental process built up over time with reference to a succession of corporate disasters and societal concerns each of which impresses the need to add another layer, principle or rule to the body of requirement increasing the level of control or monitoring over time.

This developmental process can be better understood through an appreciation of the major incidents which led to fundamental adaptation of the Anglo-Saxon model of capitalism as embraced in the US and the UK. Each incident added to the body of regulation in an attempt to eradicate the conditions under which trust could be called into question or situations in which agents knowingly acted against the interests of the principal.

Enron

Although Enron was certainly not the first documented instance of corporate greed and corruption in the modern era and although the losses incurred by shareholders and others are less than a tenth of those that arose from the failure of Lehman brothers, it still is held as the benchmark against which cases of subsequent governance failure are measured and, more importantly, the governance regulatory changes that arose following the collapse have had a greater impact on global governance than any other incident before or since (except the South Seas Bubble).

Enron was a Houston based energy company led by the cult figure of Ken Lay. During the 1990s Ken successfully lobbied (through political allies) for deregulation of the energy markets in the US thus removing them from the tight control of the US government. Once free from these shackles Ken and champion CEO Jeff Skilling developed Enron into the most successful energy trading company in the US, controlling the power stations and infrastructure for delivering gas and electricity whilst selling clients (including state institutions) contracts for energy supply.

Operating in a virtual monopolistic position, controlling the value chain from supply to customer, gave Enron enormous power and with that power came greed and inevitably corruption.

After seven years of meteoric growth, the bursting of the dot.com bubble in 2000 led to a slump in share price against which all of Enron's finances where pinned. On 2nd December 2001 the company filed for Chapter 11 protection from its shareholders sending shockwaves through global exchanges from which emerged Sarbanes Oxley 2002 and a variety of changes to UK governance in the Code revision of 2003.

The 3 year trial that followed, according to John Coffee of Columbia Law School, was as complicated as "War and Peace". The prosecution said:

"The two men at the helm told lie after lie about the financial condition of the firm".

The defence countered:

"This is not a case of hear no evil, see no evil. This is a case of there was no evil. Mr Skilling did not lie, cheat or steal."

Ken Lay was sentenced to 165 years, Jeff Skilling to 275 years.

Cadbury to Turnbull

Cadbury 1992

The development of stock exchange regulation in the form that is familiar today began in the UK in the late 1980s. Adrian Cadbury was asked by the UK government to produce a report and recommendation following the events of Black Monday October 1987 during which 25% of UK share value and up to 60% of other global exchange value disappeared during one day of frantic trading.

Cadbury was due to report to Parliament in 1991. Just prior to this another corporate scandal involving Robert Maxwell and the Mirror Group erupted in the press forcing Cadbury to refocus on the governance issues surrounding this case.

Maxwell operated the Mirror Group as both Chairman and CEO, refusing throughout his tenure to talk to shareholders whilst mercilessly plundering the employees' pension fund for cash to prop up his failing media empire. When Maxwell died, unexpectedly in 1991, the depth of the misappropriation emerged.

Cadbury's eventual report therefore focuses on the need for an effective board, the need for separation at of role at the top of the company and the need to formalise communication with shareholders.

Greenbury 1995

Greenbury was asked by the UK government to offer advice regarding directorial remuneration, then, and now, the most contentious issue in all of governance. The backdrop to his report saw the privatisation of state institutions such as Telecommunications, Gas, Water and Electricity.

As each company transferred from state ownership to floating shares on the London Stock exchange directors of these utilities awarded themselves huge salary increases in line with their new status as champions of industry. The public were incensed as to how ex civil servants could become fabulously rich overnight through no action of their own.

Greenbury identified the need for performance related pay in order to deal with this issue as well as the need for a formal independent process through which remuneration for directors should be determined.

Hampel 1998

Hampel brought together the reports of Cadbury and Greenbury in order to create the first Combined Code of Corporate Governance, a title that survived until 2010.

In addition, possibly reflecting on the work of Bearle and Means from the 1930s (see chapter 1), he criticised the role of shareholders and in particular Institutional

Shareholders such as Pension Funds and Investment Trusts for failing to take an active role in the management of firms within which they invested.

Agency is a relationship and as such has two parties both of whom must be actively involved otherwise the quality of the relationship is diminished.

Today the Hampel report has become the basis for the UK Stewardship Code 2010.

Turnbull 1999

Turnbull recognised the need to improve internal control and risk management in organisations. It was difficult for him to ignore since the greatest scandal in UK banking history had been all over the press since 1995. The bank in question was Barings and the instigator of the fraud perpetrated there was the original "Rogue Trader" Nick Leeson.

In the film "Rogue Trader" Leeson is depicted as a working class lad thrown into the complexity of the Singapore Futures Market (SIMEX) with little experience and too much responsibility. In fact, he not only traded for clients, betting on price movements of stocks, but also was in charge of the trading account used to settle balances at the end of each day. The lack of segregation of duties inevitably led to Nick using the bank's own money to pay back clients who lost in such trades, so cementing their future custom and draining the coffers of Barings to the tune of $1billion.

Turnbull formalised the need for a review of internal controls and strengthened control disclosure. Unfortunately his recommendations came too late for Barings which was unable to cover the trading losses and went bust.

SOX to the credit crunch

Sarbanes Oxley Act 2002

Sarbanes Oxley is a piece of legislation passed in the US which became the basis for corporate regulation of all US listed companies. Its scope and importance is discussed in Chapter 6. It arose through the failure of Enron and World.com and is mentioned here since its legal requirement for US firms was mirrored in three additions to the UK Code which followed in 2003.

Higgs 2003

Following on from Sarbanes Oxley (SOX) Higgs identified the lack of courage of independent directors at Enron to challenge the actions of Ken Lay and Jeff Skilling. The role of the Non Executive Directors was accordingly revised.

Tyson 2003

In order to support Higgs, Tyson recommended strengthening recruitment, induction and performance management as prerequisites of creating and sustaining an effective board.

Smith 2003

Finance at Enron was headed up by Andy Fastow. The ability to trade well beyond the company's ability to do so and hide Enron's financial weakness was his responsibility. This could not be achieved without the collusion of the auditors

(Arthur Anderson) and a compliant Audit Committee. Smith recommended strengthening the role of the audit committee to ensure it is truly independent and effective in its operation.

Turnbull 2005

Recognising the changing nature and requirement of governance, Turnbull returned to offer his advice as to the importance of risk management.

His words go unheeded in the overheating market for credit. The result is the credit crunch.

Walker and the banking crisis 2010

Sir David Walker is probably the individual most closely associated with the latest revision to the UK Code which has become the benchmark for good governance following the distressing events of the credit crunch and the demise of financial institutions on a global basis as bastions of propriety and conservatism.

In the award winning book "All the Devils are Here" McLean and Nocera identify the roots of the problem relating to deregulation of the banking industry in the US and the UK in the late 1990s. This coupled with credit rating agencies which lacked independence in reflecting the true worth of global financial institutions created the lack of external control so essential to governance. Direction from within was hampered by poor information and a lack of appropriate tools for risk management in financial services. The greed of directors and disinterest of shareholders made systemic failure inevitable leading to the deepest global recession since the 1920s.

Overview

The UK Corporate Governance Code was issued in June 2010. The implementation of the code is now managed by the Financial Reporting Council due to the failure of the Financial Services Authority to manage the events that led to the Credit Crunch 2007 - present.

Since 1992 and the Cadbury report the code has been added to as a reaction to corporate failure and scandal. It first emerged in the form recognisable today in 2003 following Enron. Since then changes have been relatively minor.

Today, the code is divided into five sections:

- Section A: Leadership of the Board
- Section B: Effectiveness of the Board
- Section C: Accountability of the Board
- Section D: Director Remuneration
- Section E: Relations with shareholders

Each section contains a number of principles. These principles are non negotiable, they must be adhered to by all those coming to the market. The way in which each principle may be achieved is detailed through a number of provisions. These provisions are advisory since there may be a number of ways in which a company can achieve the required principle.

Section by section

Principles of the UK Corporate Governance Code June 2010

Section A Leadership of the Board

- Every board should be headed by an effective board which is collectively responsible for the long term success of the company (Cadbury).
- There should be a clear division of responsibility at the head of the company between the running of the board and executive responsibility for running the company (Cadbury).
- The Chairman is responsible for the leadership of the board and ensuring its effectiveness in all aspects of its role (Cadbury).
- As part of their role as members of a unitary board non-executive directors should challenge and help develop strategy (Higgs).

Section B: Effectiveness of the Board

- The board and its committees should have an appropriate balance of skills, experience and independence (Higgs).
- There should be a formal, rigorous and transparent procedure for the appointment of new directors (Tyson).
- All directors should allocate sufficient time to discharge their responsibilities (Walker).
- All directors should receive induction and regularly update their skills (Tyson).
- The board should be supplied with timely, quality information (Walker).
- The board should undertake a formal and rigorous annual review of its performance (Tyson).
- All directors should submit for re-election on a regular basis (Cadbury).

Section C: Accountability

- The board should present a balanced and understandable assessment of the company's position and prospects (Cadbury).
- The board is responsible for determining the nature and extent of significant risk and should maintain sound risk management and internal control systems (Turnbull).
- The board should establish formal and transparent arrangements for audit relationships (Smith).

Section D: Directors Remuneration

- Levels of remuneration should be sufficient to attract and retain directors. A sufficient proportion should be performance based (Greenbury).
- There should be a formal and transparent procedure for determining pay (Greenbury).

Section E: Relations with Shareholders

- There should be a dialogue with shareholders based on an understanding of objectives (Cadbury).
- The board should use the AGM to communicate with investors and encourage participation (Cadbury).

Exercise 2: WyCo

Five years ago, the outgoing CEO and Chairman of WyCo decied to retire having nominated his second in command, Dennis Kozsky to succeed him. To investors his decision has been more than vindicated. Kozsky immediately embarked on a global acquisition strategy moving the company from its core Atlantic Telecommunications market into new technologies and new continents. Over the course of the last five years profits have increased five-fold as the company bought into new products and markets at a rate of one takeover a month.

The board of directors applaud Kozsky's intuitive leadership, appreciating his flare for identifying an opportunity. All board members are executives groomed by Kozsky to take up their positions as their predecessors retire. In reward for the rapid increase in shareholder returns all directors' salaried remuneration has tripled during the last five years.

However, not everyone is happy. Some Institutional Shareholders have questioned the opaqueness of accounting and financial reporting, especially since the company re-registered itself in a jurisdiction that does not require the use of International Accounting Standards in disclosure. Further, they feel the AGM as the sole meetings of airing their grievances is a difficult forum to use since it is literally off shore for most shareholders. Some shareholders have even questioned Kozsky's grasp of the nature of cutting edge technology used within acquired companies and whether, since it is widely recognised that he singularly makes most board decisions, he truly has the skills to appreciate their net worth.

In response Kozsky stated at the AGM that he was on a mission to create the greatest Telecommunication Company the planet had even seen and that he would go down in history as a visionary even if some shareholders failed to see and appreciate the nature of that vision.

Recently, a whistleblower has gone on record as stating that the huge risks, poor returns from investments and complete lack of audit at anything above operational level have all combined to create an illusion of success within the company and that the reality of business at WyCo was far different from the one portrayed by Kozsky.

Required:

(a) Use Transaction Cost Theory to examine the fiduciary relationship in the scenario.

(b) Identify governance weaknesses and their possible solution at WyCo.

Exercise 2: WyCo - notes for an answer

(a)

Frequency

The number of takeovers that have taken place over the past five years is evidence of frequent change

Uncertainty

The uncertainty surrounding the market the company operates in is problematic. Technology is an inherently risky market for all players within it.

Asset Specificity

Each acquisition is a unique challenge with unique risks. New technologies and new markets are specific risks the company must deal with.

Bounded Rationality

The limitations of the individual, in this case the CEO must feature in questioning the degree of trust that exists

Opportunism

The extent to which the CEO is empire building to serve his own self interests or whether this kind of growth is in shareholders interest.

(b)

The question contains problems with regard to almost all areas of the UK Corporate Governance Code.

- The lack of effectiveness of collective decision making
- The lack of CEO /Chair spilt
- The lack of non executive directors
- The lack of diversity on the board
- The lack of nomination committees
- Poor quality financial information to the board
- Lack of evaluating board performance
- No board rotation
- Lack of internal control, audit and poor quality disclosure
- Inappropriate remuneration
- Lack of shareholder relationships.

EVALUATION OF THE IMPORTANCE OF CODES

An evaluation of the importance of Codes is a difficult question to answer since the question itself is not clear.

It seems inappropriate to evaluate the importance of regulation itself since without any regulation, legal or stock exchange advisory based, corporations would have complete freedom to act and governing would be left to director discretion and shareholder pressure.

The evaluation may relate to the importance of codes as opposed to enshrining the regulation within the legal system. This argument is dealt with in Chapter 6.

Here, the evaluation simply looks at the importance of having an effective code that works in its operation and is supported by all parties in the governance relationship.

Arguments in favour

- Adopting a code improves the level of general control and the quality of decisions made within the corporation.
- This should improve profitability.
- Adopting a well-regarded code gives investors confidence in corporations and therefore attracts investment.
  - This is particularly true in promoting overseas investment.
- Quality codes give stakeholders an assurance in the good management of powerful enterprises.
  - This is particularly true for governments and the general public.

Arguments against

This is difficult since it is difficult to argue against something that is effective. However, in a general sense:

- Codes are reactive and therefore should not be over relied upon as a mechanism for reducing greed and fraud.
- Any regulation creates overhead and cost in its implementation.
- This can affect competitiveness on a global basis.
- A single approach to regulation creates an imbalance between those to whom it is necessary and those to whom it is not.
- A single approach creates imbalance between those who can absorb the cost and those that cannot.
- Any regulation reduces the freedom of directors to act even if it is in the shareholder's best interests.

Some of these criticisms were recognised by Cadbury who decided that the Code should, to a degree be voluntary, so removing the burden of full adherence for smaller companies. This is discussed again with regard to "Comply or Explain" in Chapter 6.

Chapter 3

The board of directors

ACCA STUDY GUIDE REFERENCES

- Explain the roles of internal parties in corporate governance
- Explain the roles and responsibilities of the board
- Distinguish between and evaluate two tier and unitary boards
- Define NEDs and explain their roles
- Explore the CEO / Chairman split
- Assess the importance of induction and CPD
- Describe the legal and regulatory frameworks of directors
- Analyse the process of performance appraisal

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BOARD COMPOSITION

The UK Corporate Governance code consists of two sections relating to the board of directors. The first, "Leadership" deals with the makeup of the board, dealing with the structure and defining key roles.

Beyond the UK board structure can differ significantly, possibly extending to the use of two boards rather than one and with differing levels of concern or support for Chair and Independent directors roles. The general trend towards globalisation and the need to attract investment from global financial institutions suggests that, over a long period of time, the structure of boards will rationalise towards a UK/US standard, whilst still allowing for local variants.

Board roles and responsibilities

Every board of directors has a unique sense of its role and responsibilities. However, whatever perception they have, it is important that they take the time to tangibly define and document their role so that it can be used to provide shareholders with a sense of assurance that the board has a formal view of this issue. Having defined their role the board can also use this as a basis for performance appraisal and through this attempt to continuously improve on their performance.

Responsibilities of the board

- To act in the shareholder's best interests.
- To safeguard the assets of the organisation.
- To uphold the law.
- To uphold the Corporate Governance Code.
- To uphold stakeholder obligations.

Roles of the board

- To define and implement strategy.
- To monitor corporate performance.
- To define risks and exact internal control.
- To focus on shareholder relationships.
- To evaluate board performance.

Unitary v two tier boards

The fourth principle from section A of the UK code refers to the use of a unitary board as the structural form expected in the UK. This is not to suggest that other jurisdictions follow this example.

Two tier boards consist of:

1. Supervisory tier

The upper tier usually consisting of shareholders and stakeholders who have an active interest in running the corporation or managing their own substantial investment in the enterprise.

2. Management tier

The lower tier consists of executives who manage the day to day operations of the organisation rather than defining strategic direction or dealing with the wider agency relationship.

Advantages of Two Tier structures:

- Less agency issues.
- Less executive self interest impacting on company operations.
- Lower agency costs such as disclosure.
- Lower executive pay.
- Improved stakeholder involvement.

Problems include:

- Detachment of executive from strategic input and decisions.
- Detachment of the upper tier from the lower tier.
- Less expertise on the upper tier.
- Larger governance overhead by having two boards.
- Stakeholder involvement may dilute decision making.

Non executive directors (NEDs)

The UK code is explicit about the importance and need for sufficient NEDs to sit alongside the executive on the board of directors. A NED is an outsider, voted onto the board by shareholders to act in a monitoring capacity on their behalf. At least half of the board must be made up of NEDs.

This general role is extended by Higgs 2003 into:

Strategy role

To assist the executive in the determination of strategy through their expertise in specific areas.

Scrutiny role

To monitor executive activities on behalf of shareholders.

Risk role

To assist in the risk management process, defining risks and appropriate strategies.

People role

To act as an independent function for recruitment to the board and director remuneration.

NED independence

In order to be seen to make decisions in the interests of shareholders and to operate without undue influence of the executive, NEDs must adhere to the independence criteria set out in the code:

- Not an employee within the last 5 years.
- No business relationships within the last 3 years.
- Only remunerated with a fee for director duties – no profit share or share options.
- No close family ties to the company.
- No cross-directorships – this is where the directors of 2 companies sit on each other's boards as non-executives.
- Any NED who has been on a Board for longer than 9 years is assumed to no longer be independent and will be annually re-appointed after this.
- Any NED being a major shareholder

Advantages of NEDs

- Provide expertise to the board of directors.
- Operate in a monitoring capacity to curb excessive behaviour of executives.
- Demonstrate decisions are made in shareholder's best interests.
- Facilitate stakeholder representation on the board.
- Facilitate compromise and create balance on the board.

CEO / Chair split

The Chairman is the leader of the board of directors. He must operate to the same independence criteria as NEDs in order to ensure that he is deemed to act in the interests of shareholder's without undue influence of the executive directors.

The broad role would embrace:

- Leading the board including setting board meeting agendas.
- Communicating company position to shareholders.
- Listening and acting on shareholder wishes.
- Quelling the excess of executive behaviour.
- Supporting NEDs.
- Operating as a casting vote if the board is balanced 50/50 between executives and NEDs.

Cadbury was explicit about the need to ensure that no single person had unfettered power of decision in the organisation. This requires the separation of roles between those who deal with shareholders and the individual commanding the use of company assets. This is the CEO/Chair split.

The advantages of such separation include:

- Shareholder assurance of the independence of the Chair and the quality of their relationship with the Chair.
- Ability to focus on separate roles through improved time management.
- Improved execution of roles through the use of individuals who have particular skills in these areas.
- Assurance of power on the board resting with shareholders.
- Suppression of excessive executive behaviour.

THE BOARD IN OPERATION

Board operation can be viewed in relation to the execution of their roles and responsibilities. Corporate governance offers advice to improve on the ability of the board to perform these tasks through section B of the code, "Effectiveness".

This is the largest section of the UK Corporate Governance Code, impressing the need to employ fundamental management functions at the top of the organisation in line with those that permeate all other levels of the company. The fact that the code needs to offer advice as to the need to train and induct directors, for example, is a deep criticism of the lack of professionalism at the top of many organisations.

Induction

Many of the requirements in Section B relate to failures at Enron. A lack of skills of NEDs was cited as a major weakness within the company and so subsequently featured in the UK Code from 2003.

The induction of new board members is important because:

- It provides them with the skills and information they need.
- It provides assurance that these skills exist.
- It ensures rapid assimilation onto the board.
- It removes the ability of the individual to argue they did not have the information they needed.
- It is culturally appropriate to carry induction out.

The scope of induction should embrace:

Responsibilities

- The scope of applicable legislation.
- The scope of applicable regulation.

Roles

- Induction into products and markets.
- Awareness of financial performance.
- Awareness of risks and control structures.
- Awareness of key shareholders and stakeholders.

Company secretary

Induction is the responsibility of the Chairman although this inevitably is delegated down to the Company Secretary. The role of the Company Secretary is to support the board of directors. It is usually a role carried out by an individual in a part time capacity alongside their more central function as a senior manager within the organisation. The Company Secretary does not tend to be a voting role on the board but rather operates in an advisory capacity.

The role might embrace:

- Maintaining the shareholder register and filing company returns.
- Dealing with induction and organising Continuing Professional Development opportunities.
- Organising board meetings.
- Ensuring appropriate information flows exist for the board.
- Advising the board on legal and governance issues.

Legal duties of directors

The scope of legal obligations relating to directors is vast. Legislation may be drawn through local government, national government and even obligations under international agreements such as requirements with regard to human rights. As companies grow to become multinational the scope of these obligations increase in number and complexity.

Despite this, each director ultimately has a very simple focus in order to ensure they operate within the requirements of the law. Fundamentally each director must ensure they understand and act in accordance with their duties to shareholders.

There are two duties:

- A Duty of Loyalty
- A Duty of Care and Skill

Duty of Loyalty

In order to ensure directors demonstrate an adequate level of loyalty they must make decisions in the interests of shareholders and avoid situations where this sense of loyalty may be called into question. One such circumstance arises with regard to directorial involvement in share trading.

Insider Dealing

Insider dealing arises where the director uses his privileged position, and access to confidential information not available to shareholders, in order to personally gain through share trading. Such action is a criminal offence because it acts against the free operation of the market and shareholders within the market. It is a corruption of the principle of free flow of information.

Duty of Care and Skill

All directors must act reasonably and not recklessly with regard to their decisions and actions. The extent to which a legal breach arises will depend on a number of factors including the perceived level of skill of the director through training, induction and access to information. A wealth of legislation in relation to health

and safety, employee rights and the environment, for example, exist to define the level of care and skill required by directors and the organisation as a whole.

Failure to operate with regard to either loyalty of care and skill can lead to:

- Criminal Prosecution by the State
- Civil action by the company to recover losses.

Successful prosecution will usually lead to the removal and disqualification of the director.

Removal of Directors

There are many reasons why a director may be removed from office:

- Removed for a disciplinary offence
- Through an agreed departure
- Resignation
- Personal bankruptcy
- Death in service
- Absence for more than six months
- As a result of a provision of successful prosecution under legislation
- Failure to be **re-elected** at AGM
- Through a simple majority vote made by shareholders.

Disqualification

Potential causes for disqualification of directors include:

- As a result of a provision of successful prosecution under legislation
- Allowing the company to trade while insolvent
- Failure to prepare or file accounts
- Failure to deal with tax returns.

Re-election of directors

All directors must offer themselves for re-election by shareholders on a regular basis. This may involve retirement by rotation with a third of directors standing each year for re-election at the AGM or, in accordance with the June 2010 code, may require annual re-election of all board members in large companies.

With regard to retirement by rotation, there are particular requirements for NEDs.

- Review of their position in terms of skills and independence after 6 years
- Review of skills after 9 years with a loss of independent status.

Performance appraisal

The board must evaluate its performance annually and commit to a process of continuous improvement. The criteria for such a review should be formally documented by the board and the results of the review included in disclosure.

Criteria may include:

- A review of the performance of the CEO and Chair
- A review of the performance of NEDs and the Company Secretary
- A review of the performance of board committees
- A review of collective board culture and operation
- A review of strategy and risk management
- A review of stakeholder relationships.

Importance of Performance Appraisal

- Demonstrates a sense of loyalty to shareholders
- Demonstrates a sense of care and skill by the board
- Leads to a tangible improvement in board operations
- Highlights the need for training or the need to recruit
- Supports board remuneration demands.

PAST PAPER ANALYSIS

December 2012

2 (c) Discuss accountability and its application to re-election. (7 marks)

June 2012

2 (a) Discuss the independence of NEDs. (8 marks)

3 (c) Discuss performance appraisal importance and criteria. (7 marks)

4 (b) Assess the benefits of an induction programme. (8 marks)

(c) Distinguish between unitary and two tier boards. (7 marks)

December 2011

2 (b) Assess CEO/Chair separation. (8 marks)

June 2011

1 (d) Roles of the CEO in managing issues. (8 marks)

December 2010

1 (c) (i) Discuss the importance of sound governance. (10 marks)

3 (a) Explain NED conflict of interest and issues involved. (8 marks)

(b) Assess the advantages of good NEDs at the company. (7 marks)

June 2010

December 2009

1 (c) Assess the contribution of NEDs. (8 marks)

2 (a) Content and advantages of induction. (8 marks)

(b) Evaluation of two tier structures. (8 marks)

(c) Assessment of chairman’s role. (9 marks)

June 2009

3 (a) (i) How can a director leave the services of a board. (4 marks)

(a) (ii) Discuss why it is difficult to remove a director. (4 marks)

(d) Criticise chairman's performance. (8 marks)

December 2008

2 (c) Advantages and disadvantages of NEDs. (9 marks)

June 2008

3 (c) Explain retirement by rotation. 5 marks

December 2007

1 (c) Explain the roles of NEDs and problems of NEDs. (12 marks)

3 (a) Describe the roles of the chairman. (5 marks)

(b) Discuss the separation of CEO and chair roles. (12 marks)

June 2007

1 (a) Evaluate the adequacy of governance arrangements. (10 marks)

(c) A case for unitary board structures. (10 marks)

(d) Roles of NEDs and their contribution. (7 marks)

2 (c) Possible governance strategies in cross directorships. (5 marks)

Chapter 4

Board committees

ACCA STUDY GUIDE REFERENCES

- Explain and assess the importance of committees
- Explain and evaluate the role of a nomination committee
- Explain and evaluate the role of a remuneration committee
- Assess the principles of remuneration
- Assess the components of a remuneration package
- Analyse legal, ethical, competitive and regulatory issues in remuneration

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NOMINATION COMMITTEE

Nomination committees are one of four subordinate governance structures below the board level. The full scope of committees recommended through global governance regulation is:

- Nomination Committees.
- Remuneration Committees.
- Audit Committees.
- Risk Committees.

The latter two committees are discussed within context of Internal Control and Risk Management.

Role of committees

All committees share common features which could be considered as advantages to their use.

- They allow the board to offload responsibility for a particular activity
- They provide a forum to focus on a limited and distinct task
- They should provide expertise in the given area of operation
- They should provide independence in operation and recommendation
- They provide advice to the board of directors
- They provide disclosure to shareholders
- They provide assurance to shareholders and the wider markets.

In most cases committees are optional and are considered the remit of larger corporations. The shareholders or market will decide as to when the creation of separate committees for consideration of each issue becomes significant for the individual company.

Approach to nomination

The UK code deals with nomination or the recruitment of directors to the board in section B, "Effectiveness". The code is clear concerning the need for a formal, rigorous and transparent approach to the appointment of new directors to the board.

The importance of nomination or the need to have an ordered approach through which succession is assured is possibly the most important issue in governance since without succession survival or continuity of operation of the board is called into question. Despite this it is considered of lesser significance than some other committees.

The composition of the committee typically includes a majority of NEDs to ensure independence but therefore also allows for executive involvement since this assists in gaining important perspectives on top line management being prepared for promotion to the board as well as assisting in the identification of skills shortages on the board.

Formal, rigorous and transparent relates not just to the need for a defined, independent process of nomination but also the need to communicate this policy and the rationale behind decisions made to shareholders.

Focus for action

- The need to sustain the 50/50 split on the board
- The need to avoid cross directorships
- The need to deal with re-election requirements
- The need to renew and refresh the board
- The need to sustain board skills base and adapt to changing challenges
- The need to sustain shareholder value through succession.

Process of nomination

A formal and rigorous process should embrace the following according to the June 2010 UK code:

1. The need to create a clear plan for succession to key positions
2. The need to consider board diversity
3. The need to prepare job specifications and personal profiles of requirements
4. The need to use consultants as necessary
5. The need to use open adverts to attract a wide pool of candidates
6. The need to consider each individual candidate’s existing commitments.

REMUNERATION COMMITTEE

Over 50% of complaints received by the Security and Exchange Council (SEC) each year relate to shareholders concern over directorial pay. Despite a global recession that has significantly affected employment, the earning potential of individuals and corporate profitability and growth, Executive Directors pay continues to increase at an accelerating rate outstripping any relationship with inflation, economic conditions or company performance.

This is a relatively new phenomenon. Prior to the 1980s, cultural standards of behaviour expected from those in privileged positions tended to bring directors pay in line with the rest of the organisation. By the 1990s this perception had disappeared and directors pay rocketed. However, it is the last 10 years that have seen an almost complete unshackling of wage constraint, a complete disregard for any sense of propriety in executive pay.

This serves to emphasise the importance of the role of the remuneration committee and the sense that they have failed over successive generations to curb individual greed in the board room. Listed company executives are paid approximately 500 times more than their own administrative personnel.

Principles of remuneration

Greenbury 95 suggest there are three purposes to setting remuneration:

- To attract good people to the company
- To retain good people within the company
- To motivate individuals through reward.

In order to achieve these goals he divided his section of the UK code into two areas. This is now section D of the June 2010 code.

1. Performance related pay

(a) The need to set challenging targets

Targets against which performance is judged and bonuses awarded should be aligned with the expectations of shareholders. It should include corporate and individual, financial and non-financial criteria.

(b) The need to set consistent targets

Consistency is a sense of benchmarking others in setting targets. This could include benchmarking:

- Employee or other top flight manager rewards
- Consistency between executive
- Benchmarking other industry players
- Benchmarking market expectations.

2. To create a formal rigorous and transparent process for determining pay

(a) The need to create an appropriate structure for committee operations

A remuneration committee should consist of at least 3 NEDs with no executive involvement. The Chairman usually chairs the committee although it is important to ensure that no one sets their own pay. Shareholders must approve pay awards through resolution at the AGM.

(b) The need to justify committee decisions

This emphasises the importance of disclosure of committee operations through the annual report. Apart from detailing the rationale behind pay awards the committee may seek to justify their decisions through involvement or reliance on third parties to assist in determining pay. This tends to relate to auditor involvement and ratification of decisions are being appropriate given market conditions.

Components of a reward package

Basic pay

Since performance related pay should make up the majority of the reward package salary should be limited by comparison. However, it should be enough in itself to attract and retain executives. Benchmarking should be used to set pay awards in this area. NEDs are paid a retainer for their services rather than being salaried and do not participate in performance related pay schemes.

Benefits

These could be considered as residual or expected costs in the agency relationship. The size of deferred benefit through pension schemes is possibly the most contentious part of rewards in this area. Usual benefits of use of the company fleet of vehicles etc are included here.

Bonuses

Bonuses are short term reward schemes that reward risk taking by directors to create short term dividend benefits for shareholders. Financial performance indicators could be profit led or have regard to total shareholder returns during the period. They should be benchmarked to industry performance and the most recent version of the UK code includes provision for claw back if necessary at some future point in time.

Stock options

Stock (share) options are a long term incentive scheme that rewards control, consistency and steady growth through high quality strategic decision making. Options tend to exist over a three year time period and are only available to be cashed in at the end of this period. Share price growth during the period creates the basis for the reward.

PAST PAPER ANALYSIS

December 2012

June 2012

December 2011

3 (a) Purpose of reward package and factors. (10 marks)

June 2011

December 2010

June 2010

2 (a) Performance of remuneration committee. (10 marks)

(b) Components of a remuneration package. (10 marks)

(c) Ethical case for a reduced package. (5 marks)

December 2009

June 2009

3 (c) Criticise the reward package. (4 marks)

December 2008

June 2008

3 (b) Explain the roles of nomination committees. (8 marks)

December 2007

2 (c) Benefits of performance related pay. (8 marks)

June 2007

2 (a) Roles of remuneration committee and cross directorship. (12 marks)

(b) Components of a Remuneration package. (8 marks)

Chapter 5

Shareholder relationships

ACCA STUDY GUIDE REFERENCES

- Analyse and discuss the role and influence of institutional investors
- Explain the general principles of disclosure to shareholders
- Explain best practice governance disclosure requirements
- Explore the issues surrounding voluntary disclosure
- Analyse the purposes of AGMs and EGMs
- Assess the role of proxy voting

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SHAREHOLDER DISCLOSURE

The general need for adequate disclosure is embraced with Section C of the UK Corporate Governance Code. The first principle of this section on Internal Control states that the company should:

"provide a balanced and understandable assessment of the company's position and prospects"

Such a requirement relates to all information provided by the company to the market and so includes interim results and forecasts of year end performance and market conditions. Its major focus is towards improving the quality of the annual report since this is the major mechanism for communicating to shareholders.

Content of disclosure

The annual report will generally include the following:

1. Chairman's statement

Since the Chair is the leader of the board of directors and the single true spokesperson for the shareholders it seems appropriate that communication should begin with a statement from this individual. The statement tends to be paternal in its style, stakeholder-driven in its content and designed to provide assurance in his stewardship of the corporation.

2. CEO's statement

The CEO's statement, by contrast, is more detached in its style, shareholder focused and designed to communicate the positive performance of the company. In order to deliver this it will tend to be longer than the Chairman's statement.

3. Business review

This section could also be referred to as the Operating and Financial Review. It should be assumed to be mandatory as part of the legal disclosure requirement. It should identify the business model being used and detail strategies into the future.

4. Financial statements

These should be drawn using International Accounting Standards. Their content including the notes to the accounts will form the bulk of information communicated to shareholders through disclosure.

5. Governance section

This section relates to the communication of governance policy and outcomes. It will include reports from all four committees and identify the extent to which the company has complied with the requirements of regulation whatever the jurisdiction.

Mandatory v voluntary disclosure

A central and on-going issue in governance is how much information shareholders have a legal right to. Clearly there are a number of existing mandatory requirements in disclosure:

- Business Review
- Accounts
- Notes to the accounts
- Auditors statement
- Governance section.

The question arises as to how prescriptive the law should be in detailing what should be included in the Business Review and Governance Sections. The profession of accountancy is based upon understanding the nature of disclosure with regards to the accounting sections of the annual report. In contrast, there are virtually no legal or mandatory requirements for the business review and very little solid requirement for disclosure in governance. Virtually everything is up to the company as to how much it wishes to disclose. It is virtually all voluntary.

The business case for improving the amount of information the board of directors is willing to disclose is compelling:

- Better information promotes a sense of transparency and responsibility and accountability
- This can attract investment to the company
- The annual report is a prospectus for global investors as well as local investors.

Information is the lifeblood of an effective market and so more information is in the spirit of good market operations and good governance.

SHAREHOLDER DIALOGUE

Disclosure is a form of dialogue with shareholders. The UK Corporate Governance Code June 2010 highlights with importance of promoting a positive discourse with shareholders at every opportunity. This is contained within section E of the Code.

The variety of forms that dialogue may take are detailed within the governance section of the annual report. It is the Chairman's responsibility, as leader of the board of directors, to ensure that effective dialogue takes place.

Scope of dialogue

There is no mandatory requirement with regard to the forms of dialogue that the board of directors may embrace, but the following offers a flavour of the issue:

- Annual Report
- AGM, EGM
- Meetings with the Chairman
    - Preliminary results
    - Interims
    - Forecasts
    - Market analyst presentations
- Investor conferences
- Trade shows
- Web site
- Investor Relations Department

The Investor Relations Department is a formal structure used as a first point of contact for shareholder needs and concerns. It operates as a firebreak between the shareholders and the Chairman ensuring that mundane issues are dealt with without recourse to involving the leader of the board.

Annual general meeting

The use of the AGM as a tool for communication should be viewed as a mandatory legal issue. It is a part of the Articles of Association of a corporation. The effective use of the AGM is a governance issue recorded in the UK Corporate Governance Code June 2010 within section E.

The Code calls upon the board to make constructive use of the AGM. Being constructive firstly requires all directors and committee members to make an appearance at the AGM and to ensure it is organised with adequate notice being given to shareholders (at least 21 days).

An effective AGM could be viewed from the two perspectives of the agency relationship:

Board of directors

- To use the AGM to provide a balanced and understandable assessment of the company's position and prospects
- To use the AGM to provide shareholders with a sense of assurance in the professionalism and quality of their board of directors
- To use the AGM as a tool to attract further investment in the organisation.

Shareholders

- To receive adequate information in order to promote a sense of assurance
- To provide an opportunity to question the board as to strategy and reasonably expect to have their questions answered
- To vote with regard to resolutions set before the shareholders.

An extraordinary General Meeting would have a similar focus although its use suggests a crisis of some sort and therefore the focus shifts slightly in emphasis.

Proxy voting

A proxy is a substitute, so in this instance proxy voting has two meanings:

(a) It relates to the use of an individual other than the shareholder to cast their vote at the AGM. This would be the company secretary voting on behalf of instructions received from shareholders

(b) It relates to the use of a substitute voting mechanism rather than attending the AGM and voting through a show of hands. This would be through the use of postal voting, voting through the company web site or through e-mail or, for Institutional Investors, the use of subscription based systems to collate and manage the transfer of votes in relation to the corporations in their share portfolios.

The provision of proxy voting services is a part of governance requirements in most jurisdictions.

Such an approach supports the agency relationship and, in particular, global investment. Its simplicity assists Institutional Investors exercising their voting rights although automatic approaches bring into question the extent to which due consideration is ever given to the voting decision.

ROLE OF SHAREHOLDERS

Approximately 90% of shares traded on the London Stock Exchange are either by corporations between themselves or between Institutional Investors and corporations. The role of shareholders therefore focuses on Institutional Investors since the markets operate mainly in their interests. Individual investors still have the opportunity to manage their own portfolios but their impact is negligible and so are not considered as an important governance issue.

Hampel noted in 1998 that Institutional Investors took little in the way of an active role in managing corporations that they owned shares in. He called on them to uphold their end of the agency bargain. If they did not it would become questionable as to who really cared about the excessive behaviour of directors or who would be in a legal position to act when corporations acted in an inappropriate way.

Case for shareholder action

Institutional Investors such as Pension Groups and Trust Funds act on behalf of investors, pooling their wealth and purchasing shares in the hope of generating returns for their investors and themselves. The business case for taking an active role in monitoring corporations in that portfolio recognises that there are many parties involved in this agency relationship and it is in all of their interests that the relationship should be a close one.

Benefits of positive shareholder action

- Reduces excessive behaviour of the board of directors
- Reduces risk of company failure
- Aligns board action with shareholder wishes
- Improves the quality of communication in the agency relationship
- Improves returns to investors and their clients
- Improves stakeholder perception of the markets
- Reduces the need for additional governance regulation to improve the relationship.

Reasons for intervention

Hampel offered a number of reasons why a Institutional Investor might feel it appropriate to intervene in a company in which they invest.

Intervention might include:

- Contacting the Investor Relations Department
- Contacting the Chairman
- Having meeting with NEDs or the Chairman
- Proposing resolutions for the AGM
- Calling an EGM
- Voting against the board
- Divesting of your shares.

Hampel thought the following reasons covered most potential concerns.

Issues might relate to:

1. Strategy
2. Company Performance
3. Lack of Compliance
4. Directors Remuneration
5. Risk or control concerns
6. Board composition issues
7. Issues relating to Corporate Social Responsibility.

UK Stewardship Code June 2010

The UK Stewardship Code is the second attempt to separate the need for shareholder action from the main body of governance regulation detailed through the UK Corporate Governance code. The first separate code was produced in 2005 for the Institutional Shareholder Committee but this proved ineffective.

The implementation and success of the Stewardship code has now passed to the Financial Reporting Council.

The Code states that Institutional Investors should:

- publicly disclose their policy on how they will discharge their stewardship responsibilities
- have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed
- monitor the investee company
- establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value
- be willing to act collectively with other investors where appropriate
- have a clear policy on voting and disclosure of voting activity
- report periodically on their stewardship and voting activities.

It could be argued that the existence of an agency relationship relies on the success of this code or, more fundamentally, on the belief of Institutional Investors that ultimately, as shareholders, they own and are therefore responsible or liable for corporations in their portfolios.

PAST PAPER ANALYSIS

December 2012

June 2012

December 2011

1 (b) Voluntary and Mandatory disclosure and advantages. (10 marks)

3 (c) Explain proxy voting. (5 marks)

June 2011

1 (c) AGM, EGM and benefits. (8 marks)

4 (c) What is insider dealing. (6 marks)

December 2010

1 (a) (i) Factors in institutional investor intervention. (6 marks)

(a) (ii) Why intervene in this scenario. (6 marks)

3 (c) Explain content of good corp governance report in annual report. (10 marks)

June 2010

December 2009

June 2009

3 (b) Explain the importance of chairman's statement in annual report. (5 marks)

December 2008

1 (d) Discuss mandatory vs voluntary disclosure. (10 marks)

June 2008

December 2007

June 2007

3 (b) Reasons for shareholder activism. (10 marks)

Chapter 6

Global governance

ACCA STUDY GUIDE REFERENCES

- Describe the nature of comply or explain
- Compare and contrast principle and rules based approaches to governance
- Explain and explore Sarbanes Oxley
- Identify issues raised in governance of NGO or public sector entities
- Analyse family and insider based structures
- Recognise the importance of national differences and convergence in governance
- Describe and explore global standards relating to the OECD and ICGN

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PRINCIPLES AND RULES BASED APPROACHES

The way that a corporation is managed at the highest level or the governance structure used by the organisation will depend on a wide variety of factors. Some factors determine the norm or requirement for all those issuing shares in a given market, others lead to a dominance of different forms in a market where varied structures are available and are acceptable.

- Dominant ownership structures (family, banks, government)
- Government structure and policies
- Culture and history
- Level of global investment in economy
- Legal systems.

A principle or rules based approach offer the two major choices with regard to the way in which governance is implemented. Other options such as family and insider structures operate as sub category choices within the two major choices. The existence of powerful global institutions that seek a uniform approach suggests that diversity will be eliminated over time to provide the perception of a single, homogeneous market for investors and corporations to operate within.

Comply or explain

The UK Corporate Governance Code is, and always has been, a principles based approach to governance. Companies seeking listing must accept general principles of behaviour in which they must act in order to operate at an appropriate level to sustain their listing. To this extent the principles of the Code are not voluntary. However, the way in which the corporation may seek to meet the requirement of what are very broad statements of principle is offered by the Code as advisory. The provisions of the code may or may not be followed, alternative approaches deployed or provisions simply ignored if the company believes it can meet the requirement of the principle without recourse to the provision.

Features of a principles based approach are:

- The code must be met in its spirit but not to the letter of its provisions
- In this sense it is a voluntary code
- Creates a flexible and aligned approach to governance
- Can be improved upon over time
- It is a comply or explain approach.

In as much as the company does not comply with the provisions of the Code it must explain the reasons why not to shareholders in the governance section of the annual report.

Sarbanes Oxley Act 2002

Sarbanes Oxley has been described as the greatest federal incursion into corporate America in all history. This is something of an overstatement, although it has led to major changes in the way in which US corporations are managed (generally for the better).

SOX emerged following the failures of Enron and World.com in 2001. Its authors sought to ensure that the markets would never again suffer the scale of corporate corruption and subsequent collapse associated with these two enterprises. Many of its provisions exist because of specific problems detailed in court cases surrounding these two organisations.

SOX is a rules based approach to corporate governance since it is federal law, requiring all companies coming to the market to abide by its provisions exactly. As with any other form of legislation, its requirements must be followed to the letter.

Features of a rules based approach are:

- Compulsory compliance
- Strict penalties for non-adherence
- Clarity in terms of provisions and requirement
- Sense of equality among corporations in governance requirements
- Market assurance in corporate governance.

Provisions of Sarbanes Oxley

The legislation divides into two sections. Provisions include the following:

The Role of the Board of Directors

- Use of Independent directors
- No loans made to directors
- CFO/CEO sign off of the internal control reviews
- Real time communication to the markets of information
- Notification to the markets of purchase/ sale of shares.

The Role of Auditors

- 2 partner sign off of audit
- Partner rotation every 5 years
- Keep working papers for 7 years
- No non audit work
- Creation of Public Companies Accounting Oversight Board.

Criticisms of SOX

SOX has many critics within corporate America and very few outside.

- Greatly increases the cost of governance

- Reduces the flexibility and autonomy of corporate activity
- Requires complex systems for implementing
- Reduces corporate risk taking
- Makes US companies less competitive on the global stage.

GLOBAL VARIETY

Principles or rules based approaches refer to the method used to implement governance practices in a given regime. Global variety considers the diversity of structures or corporate forms that exist regardless of whether principle or rules based approaches are used.

Corporate form may vary due to the common practice in a given country. Thus there may be differences depending on whether it operates in the private or public section; or differences due to management's decisions regarding governance needs arising from the specific challenges the company faces; and possibly due to its size as a small or medium sized enterprise (SME) rather than being a large listed corporation.

NGO governance

NGOs such as charities/ aid agencies could be grouped together with governmental institutions, public sector government departments, since both are Not For Profit (NFP) organisations, having societal rather than pure financial objectives, being stakeholder led without market influence in their operation.

The thrust of governance action for such institutions is the increasing commercialisation of operations. Thus, the need to bring the rigour of commercial life to activity from strategic to operational level. This need arises from a number of sources:

- The spending constraints imposed by financially challenged governments
- Public demand for expenditure constraint, waste reduction in institutions
- Commercial reward structures used for senior management in such institutions
- Use of management and staff from the private sector
- Cultural movement away from state ownership and provision of services.

This change is difficult to implement successfully. Because:

- Culture clash in serving a social need and operating with finance as a primary driver
- The influence of major benevolent stakeholders who may resist such moves
- The influence of management and staff many of whom are volunteers
- The ambiguity in opposing objectives of profit and service
- Lack of commercial skills to implement change.

Family structures

Jill Solomon cites a 1999 survey that analysed company structures in 49 countries. It found that only 24% of large companies had a diverse shareholding. As many as 35% could be considered family based structures. This suggests that such structures are possibly the dominant form and consideration of the implications of their use worthy of thought in a review of global governance.

A family based structure is a corporation within which the family, as a dominant shareholder group, operate in positions of authority. The world's greatest retailer, Walmart, is a family based structure.

Positive issues:

- A sense of brand association with the family
- Family expertise and contacts with powerful stakeholders groups such as government
- Strong family culture and staff support and association
- Sense of stability and continuity
- Low agency costs.

Challenges

- The quality of all family members who operate in key positions (they cannot all be good)
- Poor agency relationships if other shareholders exist
- Possible sense of family detachment from others
- Inability to accept wider governance needs and views
- lack of transparency in governance.

Since family structures are very common, in fact the natural progression of growth from a small company to a listed company, the challenges or problems are often outweighed by the positive governance outcomes.

Just as each family is unique, so the way it governs the corporation is unique. There is no standard view of what this influence may embrace.

Insider structures

Family structures are insider structures. The concept of the insider relates to a major shareholder who is also active in the management of the corporation. Family members meet this definition. They are, however, not the only example of insiders. Banks, governments or simply major shareholders who have a large amount at stake are all examples of insider structures.

The governance evaluation of such a structure must therefore be similar to that for a family structure:

- Lower agency costs for the insider
- Expertise and stakeholder relationships
- Sense of stability and continuity
- Less executive freedom to act
- Questions over minority shareholder representation and support.

Exercise 3: RotoCars

RotoCars, the US car manufacturer, and TNW, the German luxury car supplier have recently merged companies. The strategic rationale for this action related to the need of the US company to gain access to the lucrative European market, while the German company would benefit from access to new industrial technology and R&D / marketing excellence.

The new joint company was incorporated in Germany. This immediately alienated the original RotoCar shareholders who were predominantly American and saw no reason for the combined organisation to effectively move off shore. Their champion, and majority RotoCar shareholder, Jim Kirk was equally enraged by the governance regulation used in the German based company. On attending the first board meeting in Munich he could not understand why the company operated as a two tier board, or why Trade Union representatives were allowed to sit alongside billionaire shareholders such as himself.

Further, the five directors representing German banks who were original TNW majority shareholders and board members, insisted on discussing the company's position on risk management and CSR as good corporate citizens rather than supporting his proposal for a large dividend windfall for existing shareholders in order to allay their concerns over the future management of the company.

Certainly it appeared that the German banks were very influential and involved in business decision making, creating a strategic alliance between the company and its providers of finance. This was a major reason for TNW's growth over many years.

The original RotoCar shareholders have just received the first annual report from the combined company. It does not use generally accepted accounting practices and is far below the volume expected by the US shareholders. One area missing from the report are details on directorial pay although it is understood that, since the merger, US directors have been forced to bring their pay in line with their German counterparts which is ten times less than their original reward package. This has not gone down well with the directors, most have left. The first AGM for the merged organisation is about to take place although it has been noted that the combined company refuses to allow proxy voting for this meeting.

In response to these difficulties US shareholding has fallen dramatically and ownership has passed to German investors. The merger has in effect become a takeover in the eyes of the US market.

Required:

(a) Describe the governance structure at TNW and the benefits of such a structure.

(b) Briefly describe the governance structure at RotoCar and why shareholders have sold their shares following the merger.

Exercise 3: - RotoCars - notes for an answer

(a)

Insider Structure

Banks are majority shareholders and run the corporation.

Advantages

- Low agency costs and assurance in decision making
- Less executive self interest
- Less executive pay
- Less disclosure
- Access to expertise
- Access to low cost finance
- Greater suggestion of CSR

(b)

Outsider Structure

Wide, diverse shareholding with no dominant shareholders creating an insider perspective. This definition is compromised by the existence of Jim Kirk who may or may not operate as an insider.

- Poor disclosure
- Unfamiliar governance regime
- Inability to exercise shareholder voting power
- Poor director pay and loss of power and influence on the board
- Cultural differences and distance from known US markets.

GLOBAL STANDARDS

The decision by governments to adopt a principles or rules based approach to governance of markets and corporations is a high level decision and one where no agreement exists on a global basis. The existence of insider / family based structures is an area within this decision where global variety and a lack of standards can be seen.

At a lower level, the remit of a code or legislation in terms of its scope and depth is an area where, as complexity and diversity of issues increases, the tendency towards global standard diminishes. The need for national sovereignty and self-determination is a powerful driver against which individual regimes will actively seek to identify themselves as distinct from others and therefore actively resist the imposition of uniform approaches.

Against this, the immense power of global markets, global investors and multinational corporate will seeks to eradicate the differences, to simplify, to make transparent and to open the doors to investment in any market on the planet. Commercial power is set against political belief, the market v the people, business against society, although it could also be argued that it is society's best interest to lower barriers and remove differences with the promise of investment and jobs if this can be achieved.

OECD and ICGN standards

The Organisation for Economic Cooperation and Development was established to achieve exactly what its name states, to bring economies together for the benefit of all. This being the case, the name also suggests that this institution operates at the very highest level of government, taking to presidents and prime ministers, about the need to work together in order to achieve growth and prosper.

It would seem appropriate therefore to identify it as a body associated with global governance standards. If all countries and their member corporations operate using the same "rulebook" then greater understanding is promoted, greater movement of capital is facilitated and share ownership can flow easily between investors throughout the world.

OECD standards exist across all areas of governance:

- Rights of the minority shareholders
- Directors Responsibilities
- Clarity in Disclosure
- Importance of Dialogue with shareholders
- The Role of Stakeholders.

The International Corporate Governance Network is a US based institution that operates on a more detailed, practical, corporate and investor focused level. It is also advisory in creating the conditions within which global investment opportunity is created. Its advice becomes a shopping list of characteristics for successful investment. This list is referenced by those seeking investment opportunities and acted upon by corporations who want investment, adapting the way they sell themselves to investors by adopting these governance standards.

ICGN standards exist across all areas of governance:

- Use of NEDs and Committees
- Performance related pay
- Risk management policies
- Internal control reviews
- Good CSR policies.

Evaluation of global standards

An evaluation of the worth of global governance standards will depend on the perspective of the individual carrying out the evaluation. The global pension funds will see the issue from a very positive perspective. Employees made redundant because their family firm has just been taken over by a foreign multinational may have a very different view.

Positives

- Opens markets to global investment
- Provides an assurance of good governance in a market
- Improves company operations based on best practice
- Promotes multinational corporation development
- Reduces the existence of state funded institutions.

Negatives

- Reduces the existence of state funded institutions
- Loss of national sovereignty and self determination
- Job losses and change of company ownership
- Negative societal effect of these issues
- Loss of global diversity in business.

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December 2012

2 (b) Discuss rules vs principle and comply and explain (8 marks)

June 2012

4 (a) Contrast family and listed company governance. (10 marks)

December 2011

2 a) Rules and principle based approaches to the exchange. (12 marks)

(c) Assess comply or explain. (5 marks)

June 2011

3 (a) Difference between charities and listed companies. (9 marks)

December 2010

June 2010

3 (a) Distinguish between rules and principles based approach. (7 marks)

4 (a) Governance issues for family based structures. (10 marks)

December 2009

June 2009

December 2008

June 2008

4 (a) Features of a rules based approach. (3 marks)

(b) Why principle based is better. (10 marks)

December 2007

3 (c) Explain global country based governance variation. (8 marks)

June 2007

3 (d) Discuss principle v rules based jurisdiction. (4 marks)

Chapter 7

Corporate social responsibility

ACCA STUDY GUIDE REFERENCES

- Explain and explore social responsibility in the context of governance
- Explain and evaluate the interests and claims of external parties involved in corporate governance
- Critically assess the concept of stakeholders in governance
- Analyse the issues of ownership and property in the context of shareholding
- Explain the concept of corporate citizenship with rights and responsibilities

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SOCIAL RESPONSIBILITY

The theories of governance state that the corporation has a dual focus in terms of its sense of responsibility to others. The primary focus is through the agency relationship and therefore towards shareholders. Stakeholders may be considered of lesser significance with a weaker sense of responsibility. However, in the operations of the organisation stakeholders are a preoccupation with no regard to shareholder needs. Even at the strategic level, shareholder direct consideration is periodic and tempered through the actions of the Chairman, stakeholder action is constant, with immediate and profound impact and, in the end, is the basis for virtually all strategic decisions. Stakeholders should not therefore be viewed as necessarily of lesser significance.

The importance of CSR

The importance of CSR can be viewed at two levels:

- The ability of stakeholders to impact on the corporation and the need to minimise negative and promote positive interaction.
- The belief systems of the board of directors in as much as they believe that CSR is important on a personal or societal level or that a positive approach to CSR will have intangible benefits beyond obvious revenue and cost considerations.

Some authors argue against the need for corporations to become over involved in CSR activity. Milton Friedman provides three premises against which directors should gauge their level of CSR involvement:

1. The corporation meets its societal obligation through the provision of products, providing employment and paying taxes.
2. The corporation must meet its legal obligation to act in shareholders' best interests in all decisions.
3. It is for governments to decide on legal requirements for CSR. Corporations have no remit to operate above or below this level.

Against these arguments, others would point to the positive aspects of an extended policy:

- Improved revenues through good customer relations
- Improved revenues through good public perception
- Less likelihood of governmental interference in company activities
- Supportive and motivated staff
- Supportive suppliers
- Good community relationships, support and less protest and cost of protest
- Better shareholder returns through the above
- Higher ethical leadership.

Organisations that tend towards this view can be said to be demonstrating Enlightened Self Interest. This is a policy that has a positive effect for others whilst no losing sight of the corporation's primary profit motive.

The scope of CSR

A CSR policy will embrace actions focused towards defining and improving relationships with a variety of stakeholders. These stakeholders may or may not be of significance with regard to profit impact. A company may donate large sums to good causes without the need to directly reflect on whether the positive publicity attached to such action makes it a cost beneficial strategy.

Archie Carroll suggests a four tier approach to CSR. In his eyes the corporation must operate at all four levels to consider itself one that takes CSR seriously.

1. Economic Obligation

At the most fundamental level the corporation must meet its economic obligation to society. This relates to the need to generate profits for those that own the corporation or, at an even more fundamental level, to continue to exist so as to support employment and commerce within society.

2. Legal Obligation

The corporation must act within the full requirement of the law. This seems obvious and yet the difficulty in multinationals being aware of and capable of fully meeting obligations in all jurisdictions has already been identified.

3. Ethical Obligations

Carroll promotes virtue in stakeholder relationships without specifying who the company should have a relationship with or how this should operate. Fundamental concepts such as integrity, responsibility, accountability, justice and fairness are thematic of personality traits the corporation should embrace.

4. Philanthropic Obligations

This highest level requirement relates to the ability to move beyond self interest, even if it is enlightened self interest. Carroll calls for selfless acts of giving to support those disadvantaged within society. Charitable works and donations form the basis for strategy in this category.

Carroll recognises that the hierarchy of obligations can differ depending on the perceptions of the corporation and society as a whole. If the legal system is corrupt or ineffective then society would not deem it a fundamental virtue to adhere to its requirements. This being the case ethical issues may be of more significance in a CSR policy.

STAKEHOLDERS

CSR policy is geared towards meeting the needs of stakeholders for the benefit of those stakeholders and the benefit of the corporation itself. This suggests that stakeholder relationships (like any other kind of relationship) are two way or reciprocal in nature. In as much as the corporation affects the stakeholder, so the stakeholder can affect the corporation.

This simple point highlights the need to identify who these stakeholders are and the degree of impact or relationship they have with the corporation. It is also reflected in a definition of a stakeholder as being anyone who affects or is affected by the corporation.

Stakeholders include:

- Employees
- Customers
- Suppliers
- Local community
- Governments
- Media
- General public
- The Planet.

The scope of stakeholders

The nature of the relationship gives rise to the use of a variety of ways of categorising stakeholders:

1. Primary and secondary stakeholders

This distinction is between those that impact on the corporation in a major way and those that do not. Shareholders are traditionally viewed as being primary and the local community as a distant secondary.

2. Narrow and wide stakeholders

This is the inverse of primary and secondary, distinguishing between those that are greatly affected by the corporation and those that are affected to a lesser degree. The local community is often greatly affected whereas a portfolio manager has little interest in corporations in which he invests.

3. Voluntary and involuntary stakeholders

The distinction is between those who have the freedom to enter and leave the relationship and those that do not. The local community often has no choice as to whether it deals with corporate operations; shareholders always have an option.

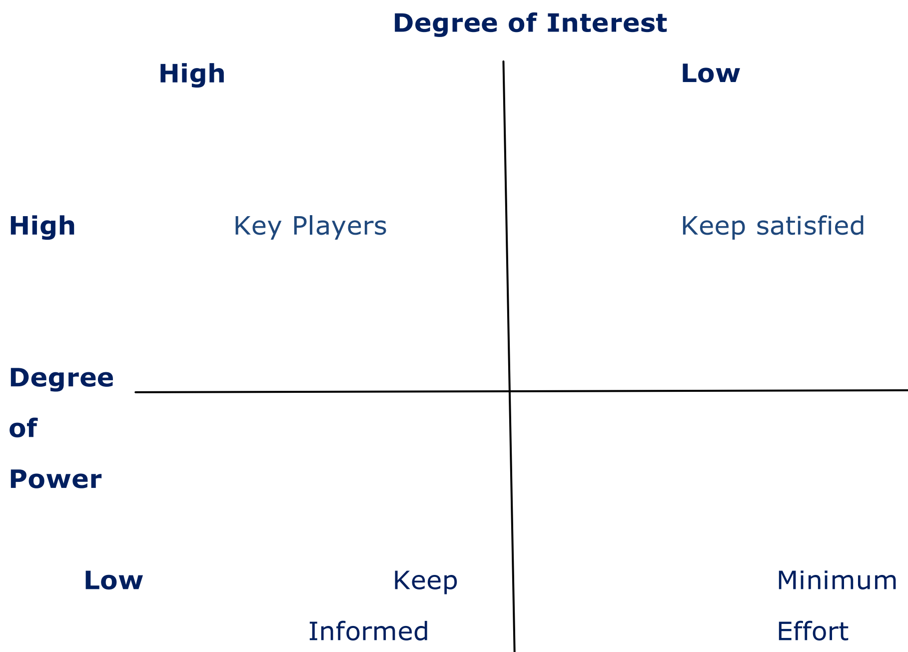
4. Legitimate or illegitimate stakeholders

This recognises the legal status of the stakeholder in terms of their actions. Protestors may trespass on company property and destroy company assets, this is illegal and such stakeholders may remain **unrecognised** by the corporation for this reason.

5. Known and unknown

This distinction focuses on the extent to which the stakeholder has been identified by the corporation and an appropriate policy defined. This is not as simple as it seems. Just because the company has not identified a stakeholder does not mean that they are not deemed to have some kind of obligation towards it. The company should reasonably assume that poor environmental practices will affect local ecosystems without necessarily having investigated what these systems are or what the extent of the impact actually is.

Mendelow model



Mendelow offers two ways of categorising stakeholders and asks the corporation to place stakeholders in the appropriate quadrant. The combination of power and interest consideration then leads to the need to define strategy within the context of advice given.

Success or failure to act can lead to the stakeholder moving position in the grid, rising from low to high or falling accordingly depending on the action taken by management.

Strategies for dealing with stakeholders

In support of Mendelow's need for corporation to act in relation to stakeholder influence, Carroll suggests a spectrum of possible strategies:

Reactive / Defensive

This suggests waiting until stakeholders act against corporate activities, possibly through protest or manipulation of the media. In this sense the defensive stance suggests that corporate action is an almost permanent state of high alert, on a war footing, willing to snuff out resistance and fight fires with any party that engages it.

Supportive / Accommodating

The corporation actively seeks to find out what societal or stakeholder needs are and then seeks to meet those needs in order to meet a given level of expectation. This identifies a sense of obligation to society and a willingness to sacrifice some effort on the basis that, on balance, it is in the company's best interests to do so.

Proactive stance

This suggests the company seeks to go beyond any industry standard or societal expectation in order to set itself apart from other corporations. The financial benefits of doing so may be significant. It is unlikely though that financial considerations are the sole issue when determining such a policy. It is likely that the corporation feels a deep sense of obligation, at the highest level of Carroll's obligations, and that it wishes to be perceived as a leader in corporate citizenship.

CORPORATE CITIZENSHIP

Corporate citizenship relates to the need to evaluate the company's position as a member of society. In as much as every individual including employees and directors are at once members of the corporation and members of society, so the corporation as an entity exists within the context of shareholders needs and societies demands.

The topic questions whether corporations can be viewed in the same way as individual citizens, whether they must exhibit the same sense of obligation given that they benefit from what society offers in the same way as an individual citizen.

Rights and responsibilities

Citizenship confers certain benefits on individuals as a matter of right simply because they exist within the context of a nation's borders. These rights include:

- Social rights to protection by the armed forces, rights to education and healthcare.
- Civil rights that protect free speech and expression, the right to political view and religious freedom.
- Political rights to impact on the political process and to gain political power through due process.

If the individual accepts this and demands this from society then it follows that they must accept the price of those rights, a given level of responsibility to society:

- The obligation to pay a fair amount of tax.
- The obligation to uphold rights and freedoms of others.
- The obligation to support the political process and, in particular, the nature of democracy.

Since the issues of rights and responsibilities are inseparable, no citizen can claim one without recognising the other. To do so puts the individual beyond the boundaries of what is considered to be appropriate citizenship. As such, society may exact some form of retribution such as imprisonment or exclusion from society for those that attempt to do so.

Corporations, like any other citizen must accept their responsibilities if they wish to be recognised as citizens.

Ownership and property

The topic of ownership and property continues with an examination of rights and responsibility, examining the extent to which the owners of the corporation accept their sense of responsibility given the nature of their rights in terms of owning the company.

To explain this complex issue, the rights of property are firstly defined to give a sense of what it means and how an individual benefits from owning property whether it is a car, a house or a share in a corporation.

Ownership of property suggests:

- The right to use the property as you like.
- The right to regulate others use of the property.
- The right to sell the asset (hopefully at a profit).

These rights have real value when considering property such as a car or a house. They have a much lesser benefit and impact for the meagre shareholder who only owns a small fraction of the whole and has minimal actual rights to use, affect and benefit from the asset.

This being the case, those that own a house have a different sense of responsibility for the asset than those who own a company. The house owner takes his responsibility seriously because of the rights benefit that exist, the shareholder may not.

This argument is used to justify the mind-set of the shareholder, the portfolio manager or the pension fund. Through this evaluation shareholders may be excused for having a diminished sense of responsibility for the corporations that they own.

Crane & Matten, who provide this analysis, suggest otherwise. They recognise the problem but emphasise that no citizen can evade their responsibility for their property. Shareholders simply must ensure that their property is managed in such a way that it does not negatively impact of society.

PAST PAPER ANALYSIS

December 2012

4 (b) Discuss the importance of recognising all stakeholders (8 marks)

4 (c) Explain stakeholder claims and assess three claims. (7 marks)

June 2012

1 (d) Discuss accountability and use the Mendelow model. (7 marks)

December 2011

4 (a) Discuss corporate citizenship.(10 marks)

(c) Discuss long and short term social responsibility. (9 marks)

June 2011

December 2010

4 (d) Criticise the policy on social responsibility. (5 marks)

June 2010

1 (a) Voluntary and involuntary stakeholders. (12 marks)

(b) Discuss Trade Unions in governance. (10 marks)

December 2009

June 2009

1 (d) Discuss narrow and wide stakeholders. (10 marks)

December 2008

June 2008

1 (a) (i) Define stakeholder and identify four stakeholders. (6 marks)

(ii) Describe the claim of each stakeholder. (4 marks)

December 2007

4 (a) Discuss stakeholders and their importance. (10 marks)

June 2007

1 (c) Identify responses to stakeholders. (10 marks)

Chapter 8

Scope of internal control

ACCA STUDY GUIDE REFERENCES

- Define and explain internal management control
- Explore the importance of internal control in corporate governance
- Describe the objectives of internal control systems
- Identify and assess the importance of the elements or components of internal control systems
- Explore and evaluate the effectiveness of internal control systems

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DEFINING THE SCOPE OF CONTROL

Internal Control is a governance issue discussed in detail in section C of the UK Corporate Governance Code.

In this sense the scope of Internal Control could be viewed as:

- C1: The need for disclosure regarding internal control
- C2: The need for a formal review of internal controls
- C3: The role of the audit committee
- C2: is dealt with in this chapter, C1 and C3 in chapter 9.

Historical background

The importance and need for internal control is as old as the concept of the corporation. There has always been a need for physical control, arithmetic reconciliation, organisation, supervision and approval over the activities of any organisation. Without the existence of some form of mechanism for control the company and its employees could simply not function.

The concept of internal control in relation to governance does not need to consider the existence of control within the organisation, some form of control, some way of monitoring or evaluating success of an activity will necessarily exist. In governance the issue is rather considering the effectiveness of these controls in pursuit of corporate goals.

The effectiveness of internal control will relate to the need to ensure that internal control embraces sufficient scope and depth, certain characteristics or components which give it a good chance of success. Consideration of this effectiveness relates to the existence of audit and auditors to review the quality of internal controls and to report accordingly.

This sense of evaluation or review by an independent party is equally nothing new to corporations. It has, by necessity, always existed, ever since the earliest days of organisation. Unfortunately, during the crash of 1720, auditors, and regulators were as compromised as those at Enron three centuries later and so completely ineffective, even so audit did exist, even back then.

So, the need for think about internal control and the need to independently review controls are nothing new in governing the organisation. The developments that have impacted on modern governance regulation are:

1. **The need to extend the review beyond evaluation of financial control.**
2. **The need to review internally as well as externally by auditors.**

1. The need to extend the review beyond evaluation of financial control

The Committee of Sponsoring Organisations of the Treadway Commission (COSO) was established in 1985 and has met on a regular basis ever since to consider the scope of necessary control within an organisation and to offer advice to corporations as to what seems appropriate.

The COSO framework developed in 1992 has become the definitive view as to what this scope should include. It does not distinguish between financial control and operational control but rather uses a broad set of headings to convey that all aspects of company activity must be monitored and their control systems reviewed on a regular basis.

Turnbull 99

Following the collapse of Barings Bank, Turnbull recommends the use of the COSO framework for control system reviews.

SOX 2002

Sarbanes Oxley distinguishes between a section 404 financial control review and a section 302 operational control review. SOX recommends COSO should be used at least for the review of operational controls, a review that supplements the traditional financial control review associated with external audit.

2. The need to review internally as well as externally by auditors

Governance requires the company to act effectively with regard to the review of its control systems and not to rely on the annual ritual of an auditor review.

It seems reasonable to assume that all managers have responsibility for reviewing the control of operations in their departments on a continual basis.

A more formal view has developed over time.

Turnbull 99

Recommends the need to reflect on the quality of audit committees and the need for more organisations to embrace the use of internal auditors.

SOX 2002

Calls for a shakeup of audit committee membership and a drive towards greater professionalism.

Smith 2003

Interprets SOX and redefined the role of the audit committee in the UK.

The scope of COSO

The COSO committee regularly offer new advice to the market reflecting current governance concerns in corporate America.

Later additions to the original framework include the need to incorporate risk management into the general review of the state of control of an organisation. This is covered in chapter 10.

In its original form the COSO framework consists of four elements. The scope of elements covers all aspects or issues that impact on the degree of control that exists in the company and so a review that covers all fours areas for each department of company operation should be comprehensive.

1. Control environment

This refers to the need for strategic management involvement in internal control. Control must begin with the need for strategic leadership and the placement of a scaffold upon which control systems can be built.

The control environment includes:

1. Structure and roles

The need to determine employee positions so as to cover all aspects of activity and the need to arrange these roles into reporting relationships so that there is a sense of integration and responsibility in organisational behaviour.

2. HR policies

Roles have to be filled by competent individuals. Strategic management must define HR policies so as to ensure that appropriate staff are recruited, trained and their performance monitored. Failure in control is usually stated as being as a result of staff failure rather than systems failure so this element is important to consider.

3. Ethics and culture

The most important aspect of the control environment will be the soft issue of culture and leadership. This permeates every decision made at and below the strategic level and a culture that lacks the restraining force of appropriate belief systems is more likely to stray into behaviours that lead the company away from probity, honestly and a sense of professional control.

Virtually all major corporate collapses or scandals are said to have a cultural failure of senior management at their root.

2. Control activities

The control environment focuses on what strategic management must accept responsibility for. Control activities suggest a delegation of control responsibility below this level and therefore the need for operational managers to develop appropriate, effective control systems, to implement such systems and continuously monitor and adapt as necessary.

The nature of control activity is dependent on the nature of the organisation. The scope and depth often depend on the size of the corporation and tend to be industry specific with enough flexibility to reflect the particular risks faced by a given company.

Value Chain analysis provides a suitable framework within which to identify the scope of controls that should or do exist and then review their quality:

- Primary activities from inbound logistics through operations and out through outbound logistics and sales.
- Secondary activities such as accounting, IT and procurement services.

3. Information and communication

Information and communication is used to:

- Link operational systems together through the value chain
- To provide feedback on system performance at each stage in operations
- Link operational management to strategic management
- Link strategic management to shareholders in the agency relationship.

A major aspect of information and communication is the use of reporting systems throughout the organisation. Reporting becomes the glue that holds the disparate elements of control together across the company.

Reporting also links directors to shareholders and investors to corporations. Cadbury suggested that "information is the lifeblood of the market" for this reason.

4. Monitoring

The final element of the COSO model relates to the importance of control over the controls.

Monitoring refers to the importance of independent auditing outside of the work of operational managers auditing their own areas of activity. As a COSO element it requires the company to:

- Consider the effectiveness of the audit committee
- Consider the effectiveness of external auditors
- Consider the need for internal audit.

Where it exists

- Consider the effectiveness of internal audit.

These issues are examined in chapter 9.

Exercise 3: Summington Sciences

Sunmmington Sciences is a world renowned biotechnology company that specialises in testing new products such as cosmetics and prescription drugs prior to certificating their use. It exists to protect the general public against unregulated products entering the market. In order to do this it carries out extensive testing of each product using animals as testing subjects. The results of this testing are then passed to Summington's clients. These clients are government health departments across the world and major multinational pharmaceutical and cosmetic companies.

Recently a scandal has erupted that threatens the future of the company. A company employee has secretly filmed testing activities within one of Summington's facilities and posted the video onto YouTube. The inhumane treatment of animal subjects shown in the film has been described as disgraceful by politicians and Animal Right Activists have threatened to blow up the Summington facility if the company does not stop operations.

Summington's major clients have begun to distance themselves from the company and some client contracts have been cancelled already. Two Summington NEDs have resigned saying the company's culture shows a deep lack of ethical belief in the well being of animals with clear failures in statutory bound levels of animal welfare taking place on a regular basis. The CEO denies the claim stating the NEDs could not possibly know what was happening at the facilities since the board only meets twice a year and never discusses operational issues. Further, the NEDs in question have no expertise in chemical testing protocols. They are both accountants and were members of the audit committee.

As clients cancel contracts, ever greater pressure is put on project teams to provide positive results to outstanding testing programmes for clients. Project teams are being given large bonuses if they can speed up the testing programmes and additional bonuses if the results of testing are supportive of clients' needs. Internal auditors have been asked to concentrate on financial and not operational control so as not to slow down these testing activities and the reporting process to senior management at the end of each phase of testing has been temporarily abandoned until the crisis passes.

Cash flow is becoming critical. Whilst hostility rages against the company on the internet, the CEO refuses to make any public statement, afraid that any admission of failure might lead to the company's financiers withdrawing credit, a move that would almost certainly lead to company failure. The Animal Rights Activists say they will hunt down any bank that supports the company, a statement that has done nothing to allay the fears of the beleaguered board at Summington.

Required:

Describe the components of a sound system of internal control and failings in each component that relate to this company.

Exercise 3: Summington Sciences – notes for an answer

Components of a sound system of internal control

Control Environment

This relates to the responsibilities of strategic management for control. It includes defining structure and roles, appropriate HR. Policies and sustaining a suitably professional culture.

Possible failures include:

- Failure to communicate the positive aspects of its mission
- Poor staff recruitment
- Cultural issues.

Control Activities

This relates to operational level control systems used to ensure the success of operations. The scope should be as broad as the business enterprise.

Possible failures include:

- Failure in physical security
- Failure in animal welfare protocols
- Threats to product testing protocols.

Information and Communication

This relates to formal and informal reporting that exists on a horizontal and vertical basis, linking company activity and providing essential feedback to management regarding organisational functions.

Possible failures include:

- Poor management reporting.

Monitoring

This relates to the control over the controls that exists through the deployment of audit functions in the organisation. Such functions can be internal or external in origin.

Possible failures include:

- Poor quality NEDs
- Poor staff audit committee
- Poor use of internal audit.

CHARACTERISTICS OF INTERNAL CONTROL

COSO provides a framework of components for a sound system of internal control.

The framework is populated through the process of review carried out by senior management, the audit committee and external or internal auditors. Such a process should be focused towards achieving certain objectives and the emerging high quality systems should exhibit certain features in the way in which they operate.

Features of a sound system

The Turnbull report of 1999 considered how internal controls should operate.

Any sound system could only be considered effective in as much as it adapted to the following criteria:

Responsive externally

Strong systems of internal control should respond to the needs of key parties to whom they are focused.

They should:

- Firstly respond to the changing needs of shareholders. This suggests that if shareholders believe credit and liquidity risk to be an important issue, the focus for control investment should be in these areas.
- Secondly, sound systems should respond to the wider needs of stakeholders. Concerns over environmental pollution should focus control investment towards environmental management control systems if this is needed.

Integrated internally

Operational systems must integrate to form a smooth operational flow of output.

Control systems through the value chain must also coordinate to ensure problems at the early stages in production are recognised and allowed for at later stages.

Integration should extend between levels of operational, tactical and strategic management to ensure everyone is aware of problems arising and their implications fully understood and dealt with.

Clear reporting channels and quality in information flow will be the mechanism through which integration is achieved.

Embedded in culture

The soft aspect of control incorporates leadership and belief.

Embedding involves training and strategic management reinforcement of belief so that actions become automatic and immediate in response to key control issues such as safety or quality management.

Embedding control focus in culture reduces the need for hard systems to reinforce its importance such as the need for supervision or audit of processes. The importance of the issue does not however mean that it can take anything other than primary importance in the minds of those involved in control. It is just that assumptions can be made that people understand and deal with the issue rather than needing to be repeatedly told to deal with safety and quality concerns.

Objectives of a sound system

Turnbull 1999 also provided a sense of goal for an effective system of internal control. The choice of objectives by Turnbull should be considered in the context of what he was trying to achieve through his report.

Turnbull wished to persuade the owners of the company to invest in improving control and their representatives to focus on the task in hand.

He also wanted to ensure that the agency relationship between the two was reinforced through the existence of effective systems.

1. To ensure effective operations

This objective is focused towards the board of directors, persuading them that they have a greater likelihood of meeting their financial and other objectives if systems of internal control are improved.

Effective operations include:

- Safeguarding of assets
- Reducing fraud and misstatement
- Improving understanding of key operation issues
- Improving quality
- Reducing costs
- Improving productivity and service provision
- Improving profits.

2. To ensure compliance

This objective is focused towards the shareholders.

A sound system of internal control is a necessary part of good governance and compliance with the principles of the UK code (section C2). So, the shareholders must promote concepts of reviewing and improving controls in the spirit of owning a well governed organisation that is fit for purpose on the UK exchange. At a deeper level, sound systems ensure the company is compliant with its legal obligation to remain a going concern.

Compliance may also relate to specific accreditation goals for quality or compliance with environmental or health and safety regulation. All are assisted in their achievement through the existence and maintenance of effective systems.

3. To improve reporting

Better feedback on operations improves reporting to management internally and increases the likelihood of effective control occurring.

Improved reporting also has an external meaning relating to improvement in disclosure. This is achieved through the audit committee report providing shareholders with the information they need to support investment decisions. It also flows through the dialogue between the board and shareholders, greasing the operations of the market as Cadbury had requested.

PAST PAPER ANALYSIS

December 2012

1 (e) What are board responsibilities for internal control? (9 marks)

3 (a) Explain typical reasons why internal controls may fail (5 marks)

3 (b) Identify internal control failures in the scenario. (10 marks)

June 2012

1 (c) Explain the purposes of internal control and control assessment. (12 marks)

December 2011

1 (c) (i) Identify internal control failures. (10 marks)

June 2011

1 (a) Explain internal control measures needed to mitigate risk. (12 marks)

December 2010

June 2010

3 (b) Explain the advantages of internal control standards. (10 marks)

December 2009

1 (b) Analyse internal control failures. (12 marks)

June 2009

1 (b) Explain five typical causes of internal control failure. (10 marks)

December 2008

3 (a) Identify the objectives of internal control. (5 marks)

June 2008

1 (e) Explain difficulties in maintaining sound system of internal control. (4 marks)

December 2007

June 2007

4 (a) Explain the qualities of a sound system of internal control. (10 marks)

Chapter 9

Audit and disclosure

ACCA STUDY GUIDE REFERENCES

- Describe and analyse the work of an audit committee
- Explain the importance and characteristics of the audit committee relationship with external auditors
- Assess risks to auditor independence
- Describe the importance and functions of internal audit
- Assess the need for reporting on internal controls
- Describe the content of a report on internal control
- Explain the need for adequate information flow to management
- Evaluate the qualities of good information in information flow to management

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AUDIT COMMITTEE

Section C3 of the UK Corporate Governance Code discusses the importance of audit committee functions in governance. They are the central hub of control relationships linking together the work of managers and internal and external auditors to provide the board and shareholders with the information they need to make informed decisions.

The quality of this information will depend on the qualities of the members of the committee. Issues of independence and expertise become paramount and are dealt with through the need:

- To ensure the committee consists exclusively of NEDs. There should be at least three NEDs.
- At least one should have expertise in audit and financial reporting.

Role of the audit committee

Following Sarbanes-Oxley, Smith in the UK defines the role of the audit committee:

1. Review events and police policies

Although the full scope of internal control should form the basis for formal review, the reality of the work of an audit committee is that it must focus on shareholders' primary concern which relates to the effectiveness of financial control. This element of the role is the equivalent to a section 404 financial control review in Sarbanes-Oxley.

2. Review systems

This is the equivalent to a Sarbanes-Oxley section 302 review of operational controls. Its scope, as recommended through SOX and the previous work of Turnbull 1999, should utilise the COSO framework as the basis for the review. Failures in control systems will form the basis for recommendation of change to the board of directors.

3. Review external audit relationships

The quality of financial control is the major focus of external auditors in determining the true worth and trading position of the company. Shareholders and the audit committee will, in part, rely on the work of external auditors and so a professional relationship that is clear from any suggestion of self interest or undue pressure being exerted upon auditors must be created and sustained

4. Review internal audit relationships

The section 302 review relies, in part, on the integrity of the audit committee's relationship with internal auditors. There is no requirement in governance for the corporation to employ or create a separate internal audit department although the city assumes that the larger the company gets the greater will be the likelihood that such control structures exist.

External auditor relationships

There are potentially three aspects to an effective external audit relationship:

1. Practical Agreements

- Terms of engagement
- Determination of Fees
- Process for selection
- Policy for removal (must be explained to shareholders if this is used).

2. Assurance within Audit Firms Policies

- Existence of audit firm code of ethics
- Audit firm training policies
- Audit firm whistleblower channel
- Audit firm disciplinary procedure policy
- Audit firm complaints procedure.

3. Dealing with the threats to Independence

There are a number of potential threats that create a client hazard in the audit relationship. Such a hazard occurs when the independence or objectivity of the audit firm is called into question. If such a situation exists then the quality of information supplied and opinion delivered to the audit committee is open to question.

Dealing with the threats to independence is simply another aspect of establishing and sustaining trust in the governance structures of the corporation. Trust is an essential commodity in any business relationship.

Threats to independence

1. Self Interest

Acting in self interest is a natural part of any relationship. Here the threat is as to the extent to which that self interest clouds the judgement of the auditor and leads to a situation where the truthfulness of their disclosure is called into question.

2. Self Review

Any situation in which an individual is placed in a position to assess the quality of their own work creates a difficult ethical judgement between self interest in avoiding self criticism and the need to remain detached and objective in deliberations and recommendations.

3. Familiarity

The existence of personal relationships or a sense of personal allegiance to individuals or corporations may test the resolve of the auditor to remain goal focused and emotionally distanced from audit situations and subsequent judgements.

4. Intimidation

Applying pressure to persuade the auditor towards a given opinion may take the form of overt or covert threat. This could be a threat regarding possible termination of the audit contract as occurred between Andy Fastow and Arthur Anderson at Enron or could be personal intimidation of an auditor carrying out their role by the CEO or other finance staff.

5. Advocacy

To advocate is to support a given viewpoint. It also relates to supporting or speaking for another individual. Auditors are often act in an advocacy role, offering impartial advice to shareholders on board strategic intentions in areas such as takeovers or mergers. The reliance shareholders place on this sense of impartiality is such that the objectivity of the audit firm's views cannot be allowed to be called into question. Removal of familiarity, intimidation and self interest threats should go some way to improving the perception of independence in the advocate's voice.

INTERNAL AUDIT

The existence of an internal audit function within the corporation is a comply or explain issue. The principle is to ensure effective or sound systems of internal control exist within the enterprise. How this is achieved is for the company to deliberate on and structure in a way that it feels is most appropriate.

However, as the company grows as a listed entity, it will become harder and harder to provide explanation or excuse as to why the company refuses to take the step to formalising its relationship with internal control through the existence of an internal audit function.

Reasons for internal audit

Turnbull 1999 addresses the need for internal audit as a part of his report into Barings Bank. He suggested that, during the deliberation as to whether or not the business should establish a separate internal audit function, the following factors may offer the basis for the discussion.

Scale and diversity

The size of company operations and its complexity. Clearly the increasing size and diversity makes it more important to deal with these issues through internal audit.

Number of employees

The number of employees may represent a proxy for size of company operations. It may also point to the importance of internal control in areas such as safety and quality in large scale manufacturing environments.

New risks

Strategic change or environmental change can change the risk profile faced by a company. The bankruptcy of UK banks has created new credit and liquidity risks for many corporations that can no longer secure traditional sources of funding.

Structural changes

Downsizing, restructuring, takeovers or global market development all create conditions within which the quality of internal control is called into question. Internal auditors must start at the operational level and build control for new areas of operation prior to retiring to their evaluation function and leaving operational managers to handle day to day control activity.

Unacceptable events and failure

A major failure in control will generally lead to a need to review the area of operation and make changes. One change might be to introduce an independent internal audit function if one has not existed before. One benefit is the extent to which this may offset shareholder and stakeholder concern of a future repeat of the failure in incidence occurring.

Role of nternal auditors

There is no definitive view of the role of internal audit. Most views of the role take internal control as a starting point and simply state that the role of the internal audit is to deal with control whatever its scope and depth.

This is a reasonable view, although regulatory authorities and Institutional Investors that define the exchanges of the world would hope for some sense of formalisation of the role beyond this vague statement.

The idea also fails to appreciate the governance relationship that creates the need to consider the role of internal audit. The governance structure of significance is the audit committee. It is this committee that has the responsibility to deal with both external and internal auditors. This being the case the role of the internal auditor should be viewed with regard to the extent to which it truly supports the work carried out by the audit committee.

Internal audit should therefore:

1. Review the events and police the policies

This sees internal auditors as foot soldiers in the battle for internal control operating in the front line of financial control. Any audit testing process is essentially the same:

- Identify the system
- Identify the standard of control necessary
- Identify the scope of controls that exist
- Test controls for effectiveness
- Recommend and report as appropriate.

2. Review systems

The diversity of COSO suggest the remit within this area could be very varied.

- Management audits
- Quality audits
- Environmental audits
- Safety audits
- Accreditation audits
- Legal compliance audits
- Value for Money Audits.

3. Support external auditor relationships

The work of the internal auditor is tangible and intangible support for external auditors. In a tangible sense their working papers and results can reduce the need for external auditors to carry out separate investigations. Intangibly the existence of an internal audit function provides external auditors with some degree of assurance that internal control is being professionally and independently dealt with in the corporation.

This final issue of assurance is important. Internal auditors provide external auditors with a degree of assurance that internal control is being dealt with adequately in the organisation.

The existence of an independent internal audit function also provides others with a sense of assurance in a similar way. Key stakeholder groups include:

- The audit committee
- The board of directors
- Shareholders
- The exchange markets
- Employees
- Local communities
- Governments.

DISCLOSURE ABOUT INTERNAL CONTROLS

Section C1 of the UK Corporate Governance Code requires the corporation to provide:

"a balanced and understandable assessment of the company's position and prospects"

This need has already been discussed in chapter 5 with regard to general disclosure in the annual report.

Section C of the code is titled "Internal Control" so although the above general disclosure need is discussed within this section, the real focus for discussion should be disclosure regarding internal control. The "balanced and understandable" remit therefore resonates with regard to internal control as much as the rest of the content of the annual report.

Giving due care and attention to this issue is important for a number of reasons:

- It is a compliance issue (as identified)
- It creates a sense of transparency in control activity
- It provides assurance to shareholders
- It provides assurance to stakeholders
- It attracts investment to the company.

External disclosure

There are two aspects to disclosure regarding internal controls:

1. The need to identify those responsible for internal control

The entire board of directors must accept some degree of collective responsibility for safeguarding the assets of the company. More specifically, the audit committee must be identified and statements made to the effect of accepting responsibility for this issue.

2. The need to identify the process of review

The audit committee will identify the COSO framework as being applicable for a general review and detail the process of engagement with this framework and the results and recommendations that have emerged from that process.

Internal reporting

Turnbull's objectives for a sound system of internal control identify the need to improve reporting as the third and final objective. Such reporting should primarily reflect on the need for sound systems to be created and reviewed so as to provide the basis for improved disclosure regarding internal control in the annual report. However, improved reporting also suggested the need for sound systems to be created and reviewed so as to provide the basis for improved disclosure regarding internal control internally, to strategic management, to the audit committee, to operational managers responsible for each area of operation.

This improved feedback must exhibit certain characteristics:

- Relevance

  To the individual decision maker or manager involved in the decision.

- Accuracy

  A distinction between statistical fact and statements of opinion should be made.

- Timely

  Data must be available in good time to allow the manager to reflect upon it and determine an appropriate course of action.

- Clarity

  Reports should be appropriately structured for management consumption.

- Conciseness

  Necessary levels of summarisation assist in swift absorption of relevant facts.

- Location

  In a global information environment transfer and access to key reports becomes a preoccupation for Management Information Systems.

- Confidentiality

  Technology must support appropriate security measures to reduce the risk of hacking or general unauthorised disclosure.

The structure and depth of information supply to management internally is a complex issue for managers and technologists to consider. Characteristics that influence such decisions include:

- The nature of corporate activity and Key Performance Indicators
- The number and structure of staff and reporting relationships
- The nature of technologies used (formal and informal systems)
- The level of integration, openness or confidentiality required
- The extent to which control information extends beyond data simply relating to control into the world of risk identification and risk management.

PAST PAPER ANALYSIS

December 2012

3 (c) Discuss qualities of good information and how to improve information flow to management. (10 marks)

June 2012

3 (a) Discuss conflict of interest for auditors. (10 marks)

December 2011

June 2011

3 (c) Role of an audit committee. (8 marks)

December 2010

1 (c) (ii) Discuss the case for mandatory reporting about internal controls. (8 marks)

(iii) What this disclosure include should. (6 marks)

June 2010

3 (c) Explain internal audit testing and role of internal audit. (8 marks)

December 2009

1 (d) Importance of information to internal control. (6 marks)

(e) Characteristics of good information. (6 marks)

June 2009

1 (e) Describe roles and responsibilities in internal control. (10 marks)

December 2008

3 (a) Explain factors in creating internal audit function. (5 marks)

(b) Criticise the internal audit arrangements. (10 marks)

June 2008

2 (a) Explain auditor independence and 3 threats to independence. (9 marks)

4 (c) SOX content of a report on internal controls. (8 marks)

(d) Examine external reporting and small companies. (4 marks)

December 2007

1 (d) (i) Importance of internal controls. (6 marks)

(ii) Improvements in internal controls. (6 marks)

June 2007

2 (a) Reasons for an audit committee. (10 marks)

(b) Reasons for outsider appointments (auditor). (6 marks)

(c) Importance of independence in auditor reporting lines. (4 marks)

Chapter 10

Risk identification

ACCA STUDY GUIDE REFERENCES

- Explore the importance of risk management in corporate governance
- Explain and evaluate roles in risk management
- Evaluate the role of a risk committee
- Describe a framework for board level consideration of risk
- Assess the role of a risk manager
- Explain the dynamic nature of risk
- Distinguish between strategic and operational risk
- Define and explain common business risks
- Evaluate the nature of business and financial risks
- Recognise and analyse the industry specific nature of risk
- Explain the concept of correlated risk factors
- Explain the sources of accurate information for risk analysis

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ROLES IN RISK MANAGEMENT

Risk management is the natural precursor to an evaluation of the quality of internal controls. It makes sense to firstly identify the nature of risk exposure facing the organisation and then develop strategies for dealing with these risks including the development of appropriate control systems. The final step would then be to continuously evaluate the quality of such systems as a part of good governance.

The reason that risk follows rather than precedes internal control as a governance issue is that the history of governance focuses firstly on internal control through the work of Turnbull 1999. It is not until the early years of the 21st century that governance turned its attention fully to developing the general need for control by improving its focus through risk management.

Rationale behind risk management

Turnbull's 2005 return to the governance arena, following years in the wilderness when Smith was left to define the role of the audit committee in 2003, saw him shift his focus away from Internal Control towards Risk Management.

In his advice regarding the nature of a monthly control review to be carried out by the audit committee he includes risk issues. The focus for such a review was to include:

- Changes since the last review
- Failure incident in control systems
- Review the quality of management
- Review the quality of reporting and information flow
- Review the quality of internal audit arrangements
- Consider new risk exposure.

The rationale behind including risk management in governance would seem fairly obvious:

- Failure to deal with risks can threaten corporate continuity
- Investment in control must be focused to where it is most effective
- Shareholders expect this to be dealt with
- Stakeholders will benefit from dealing with it
- It provides the focus for all subsequent control activity.

Turnbull 2005 is however keen to point out that the inclusion of risk management governance structures or formalised activity should not be assumed to have application to all organisations in every circumstance.

In a moment of near genius he brushes off his criteria for the existence of internal auditors and uses it to offer a framework for board consideration of the need to develop its governance into the risk management environment.

The criteria are:

- Scale and Diversity of company operations
- Number of employee
- Risk profile of the corporation
- Structural changes during the period
- Unacceptable events and failures.

Deliberation of these issues lead the corporation towards the need for a risk committee and independent risk managers.

Risk committee

Since risk management is a relatively new area of governance there is often very little solid principle or rule based requirements upon which the corporation can build their expertise in this field.

The risk committee is one such area where the UK Corporate Governance Code does not offer any advice with regard to its composition or operation. It would however seem reasonable to base the structure of the committee on a committee form already used within the general nature of regulation.

Audit committees and remuneration committees have a strict requirement for total independence outlawing the use of executives so as to ensure that the threats to independent audit are not present in the decisions of the former and that no one determines their own pay in the case of the latter.

This seems excessive with regard to risk committees and fails to appreciate the positive aspects of specialist expertise that can be gained from executive involvement. Risk management also has a significant impact on operational areas and so there is a clear need for executive management to be supportive of this activity. Involvement in the strategic decision making process through membership of the risk committee will go some way in engendering this necessary support.

Appropriate advice would therefore be to populate the committee with both executive and non executive membership. In order to ensure self interest does not take precedent over shareholder interests, the committee should be majority non-executive in its composition.

Benefits of the use of a risk committee would include:

- Independence in decision making
- Separation of the function to provide focus and communicate importance
- Support for the board of directors
- Support for the audit committee
- Hierarchical reporting structure for risk managers.

Risk management involves a number of practical phases through which decisions are made. The staged process would form the basis for risk committee operations:

1. **Identify risks**
2. **Estimate impact and priority**
3. **Develop solutions**
4. **Implement risk strategy**
5. **Review, adapt and disclose.**

Risk manager

Risk managers emerged in the 1990s as a separate corporate specialism. This is not to suggest that they would not have existed for generations in high risk industries such as oil, financial services and aircraft manufacture, it is just that by the turn of the century the need for experts was gathering momentum as a governance necessity for any large listed company.

Risk managers have a number of characteristics:

- Industry specific
- Tactical function
- Advisory to the risk committee
- Coordinating function for risk policies across departments
- Staff support and training function.

The risk manager as a coordinating function emphasises the importance of risk awareness throughout the company, through the hierarchical chain and across all operational functions.

RISK ANALYSIS

Risk analysis is the first step in creating an effective risk management programme and so the first issue for risk committee consideration supported through advice given, and investigations carried out, by the risk manager.

There are two aspects to risk analysis:

1. **Risk Identification**

   This would encompass continuous assessment of existing, known risks as well as the need to ensure the committee keeps abreast of the changing nature of company operations and the subsequent changing nature of risk exposure. Turnbull's 2005 reasons for a risk committee highlights this point.

2. **Risk Assessment**

   Each risk must be evaluated through formal techniques to determine its priority. Priority will require consideration of the impact of the risk on the corporation and stakeholders as well as an assessment of the likelihood of risks manifesting into negative corporate events.

   Risk assessment is dealt with in chapter 11.

Corporations do not exist in an unchanging world, nor are unchanging within their own operation. There is a spectrum of change across which the organisation can assess its position. This position will occur somewhere between static and chaos.

Whatever the positioning, it is a given that corporate environments and operations are dynamic. It is simply the level of dynamism that changes, perhaps according to management style within and industry norms outside.

Dynamism asks the company to accept that risk management and, within it, risk analysis is a dynamic or changing process. The risk profile of a corporation that existed in the last decade will be very different than that that exists today and tomorrow's risk profile will change again, probably at an increasing speed of change to a point where society tires of change or the products produced within the industry.

Risk categorisation

Every corporate risk profile is unique. When Turnbull introduced UK corporations to risk in 2005 he realised that such a statement offered nothing to those entrusted with the responsibility for dealing with risk and did little to assist him in persuading corporations to buy into the idea.

He therefore offered a categorisation of risk as a starting point for board deliberation. Naturally, it was not supposed to be comprehensive but simply an identification of threats which are generally considered to be of significance by most companies.

Market risk

This has a multidimensional feel. Since Turnbull is promoting good governance, market risk could relate to the threat of negative perception within the exchange and volatility in share price. It could also relate to the corporations market place and so competitive threats and problems of operating in new commercial markets.

Credit risk

Clearly in 2005 Turnbull would not have expected too greater concern over credit availability since this existed in abundance. Two years later, and continuing on until today, companies struggle to access sources of finance and suffer from an inability of their customers to meet corporate credit terms.

Liquidity risk

This is the outcome of credit risk. Liquidity or cash flow problems can derive from an inability to access sources of finance, they could relate to problems of customers paying their bills or suppliers demanding cash payment. They can have stock holding implications, labour wage implications and, of course, ultimately, survival implications.

Derivative risk

This is the only risk which is not generic for all corporations. It could be considered as a specific warning to financial services institutions to deal with the hazard arising from investment or trading decisions. These risks can multiple considerably where complex hedging strategies and futures trading exist. Lehman Brothers would appreciate this being included in the list.

All of the above are financial risks

Legal risk

This relates to the general, global nature of litigation that the corporation is exposed to. It may suggest the need for appropriate reserves to be set aside in case of major class actions by disgruntled stakeholders or simply stress the complexity of legal exposure on a global basis and the increasing litigative nature of many societies.

Technology risk

All companies of any size are, to a greater or lesser extent, dependent on technology. As a threat this may include the threat of project failure, security breaches or even obsolescence. The pervasive nature of technology, speed of innovation and how technology intertwines with service delivery and marketing all suggest this is a major factor for most companies.

Health and safety risk

Compensation claims and the increased likelihood of legal action flowing from an increasingly well protected and litigation prone society could be discussed here or under legal risk. Health and Safety risk could be the most ethically focused risk category since it could reflect on the sanctity of human life and suffering that comes from health and safety failure as being reasons in themselves to consider this risk area.

Environmental risk

Since the environment has been considered a central plank in CSR policy over the last decade, management have a heightened interest in this area. So do stakeholders. The impact of failure to management the environment in the appropriate way could be viewed as a profit related self interest risk factor or, given an ethical level of board operation, important in its own right to secure the planet for future generations enjoyment.

All of the above are specific business risks.

Turnbull provides two further categories:

Probity risk

Probity, in this context, is a need to be perceived to operate at the highest level of ethics or at least to operate in a generally honest way with a sense of fairness and integrity. Failure in many of the above categories ignites a probity risk in company operations.

Reputational risk

Failure in any of the above areas can have a knock on effect on reputation. The multiplicity of factors that can trigger it and the intangible nature of its depth and longevity of outcome force the board to focus on its management.

Most risks suggest the need for consideration at both the strategic and operational level.

Strategic risk

Turnbull's classifications are aimed at the board of directors as major strategic risks. Such a risk has wide and deep implications, potentially threatens corporate success, needs major investment and policy should be determined at the highest level.

Operational risk

An operational manager is faced with many risks. Health and Safety, technology and the environment would all affect factory operations. In this sense the nature of risk considered or impacting on the operational level is the same as that impacting on the board of directors.

A distinction between the two would lie in the fact that operational risk are:

- More selective or limited depending on the area of operation
- Should have a more limited impact as an isolated event.

Risk correlation

There is a correlation or relationship between strategic and operational risk. Increased risk exposure at the lower level leads to a corresponding increase in exposure at the strategic level. An increase in one increases the other. This is a positive correlation between risks.

There is positive correlation between many risk categories:

- Increased credit risk increases liquidity risk.
- Increased environmental risk increases legal risk.
- Increase in any risk increases reputational risk.

This relationship between risks should be appreciated by the board and an integrated strategy developed that seeks to address the root causes of failure so that the impact of failure does not ripple out from the centre and increase risk in related areas.

It is also true that many risks are negatively correlated. A decrease in one increases the other or an increase in one has an opposite effect on the other risk category.

This is negative risk correlation. Reducing business risks through investment in safety or environmental systems creates pressure on finances. There will be limits to how much business risk can be reduced before the increase in financial risk becomes intolerable.

Exercise 4: Casino

Flex Entertainment owns and operates casino's around the world. From its Las Vegas base it has built an empire of luxury hotel and gaming facilities around the world. Each venue boasts cutting edge architectural design and five star service to create a gambling experience unsurpassed by its competitors.

All of this comes at a price. Construction projects are enormously expensive and the life span of each building limited and shortening in a world that craves constant innovation and reinvention. Casino locations are often in holiday resorts far away from city locations where resources and local building expertise is often in short supply.

The recent financial crisis gripping the globe has had a number of ramifications for Flex Entertainment. Some have been positive, although accessing finance to support its continued expansion is not one of them. The company is badly overexposed, and the market knows it. Recently, competitors have been sounding out institutional shareholders about the possibility of a takeover bid for the company. Such a move might inject much needed capital but would mark the end for the current board of directors. Unsurprisingly, they have rejected the idea as not being in shareholder's best interests.

At the operational level, technology is used in a variety of ways by the casino to provide entry level and unexpected gaming experiences for its clients. Theme park thrill rides are one such addition to Flex casino services that customers seek out as a welcome distraction from the tables. Strict operational regulation of such technologies is an expected cost of providing them and one that Flex ensures is met through the use of high quality maintenance and operative personnel.

Flex uses its US cultural expertise in entertainment to ensure all of its customers enjoy the very best that a gambling establishment can provide. The existence of such a facility is not however fully supported by all members of society in some of the countries in which the company operates.

Recent regional political tensions and potential regime change in some areas have left the company reflecting on its own position, that of its personnel and whether it has any assurance with regard to the safeguard of assets it owns.

Required:

Identify the risks Flex entertainment is exposed to, and discuss sources of information that can be used to assess exposure to these risks.

Exercise 4: Casino - notes for an answer

1. Project risks

These relate to the risks associated with individual construction projects carried out by the company.

Information sources include:

- Past experience
- Project managers
- Local consultants.

2. Credit risk

This relates to the difficulties in ensuring adequate finance exists to complete each project and support corporate cash flow.

Information sources include:

- Opinion of the providers of finance
- Chairman's view on equity finance
- Forecasting of operational cash flow.

3. Market risk

This relates to the risk of being taken over by a competitor in the market. It could also relate to the risk of competitor action to attract customers.

Information sources include:

- Market research
- Market analysts opinion
- Chairman's views on shareholder support.

4. Technology risk

This could relate to the threat of project failure, the threat of obsolescence of technology or health and safety risk in its operation.

Information sources include:

- Industry benchmarking
- Safety certification accreditation
- Individual project management assessment.

5. Political risk

This could relate to the unlawful appropriation of the company's assets or terrorist threat to company operations.

Information sources include:

- Views of NEDs.
- Views of local agents.

PAST PAPER ANALYSIS

December 2012

1 (d) Discuss strategic and operational risk (8 marks)

June 2012

2 (b) Discuss the role of risk committees. (9 marks)

(c) Assess risk management in small and large companies. (8 marks)

December 2011

1 (c) (iii) Health and safety risk and factors. (4 marks)

June 2011

December 2010

2 (c) Explain environmental, strategic and operational risk. (10 marks)

4 (a) Explain liquidity risk and its significance in this question. (5 marks)

June 2010

December 2009

June 2009

4 (a) (i) Role of the risk manager. (4 marks

(ii) Assess his understanding of the role. (4 marks)

(d) Evaluate risk management. (7 marks)

December 2008

1	**(b)**	**Distinguish between strategic and operational risk.**	**(10 marks)**
2	**(a)**	**Roles of a risk committee.**	**(6 marks)**
3	**(c)**	**Explain market risk.**	**(5 marks)**

June 2008

December 2007

June 2007

3	**(c)**	**Contribution of a risk committee.**	**(4 marks)**
1	**(b)**	**Risk identification and assessment.**	**(15 marks)**
4	**(b)**	**Define reputational risk, and its importance.**	**(8 marks)**

Chapter 11

Risk assessment and strategy

ACCA STUDY GUIDE REFERENCES

- Explain risk appetite and how this affects policy
- Assess stakeholder impact of business risk
- Analyse risk mapping concepts
- Discuss objective and subjective risk
- Investigate TARA and its implications
- Explain ALARP
- Analyse embedding risk as a concept
- Explain risk diversification
- Describe risk auditing
- Explain the importance of externally reporting on risk.

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RISK ASSESSMENT

Risk assessment is the second stage in risk analysis. The identification of risk provides the basis for a formal examination of the depth of risk exposure as a precursor to defining the organisations risk strategy.

The goal is, in part, to prioritise risk so as to provide board focus with regard to what is truly problematic. This prioritisation helps to make decisions as to what to do and how much investment needs to be made in minimising exposure.

There are a number of influences which impact on this assessment process:

Risk attitude

Board culture helps determine the extent to which risk is embraced or mitigated through strategy. The corporate appetite for risk in seeking out new markets or in embarking on innovative product development will greatly influence whether it considers such strategies to be risky and what it decides to do in order to minimise or avoid such risks.

Stakeholder analysis

Risk exposure is the extent to which stakeholders including shareholders may be negatively affected by a threat or hazard. A stakeholder analysis becomes an inherent part of risk assessment, influenced by corporate positioning in terms of how much it cares about potential negative impact on local communities, suppliers, governments of customers.

Risk aptitude

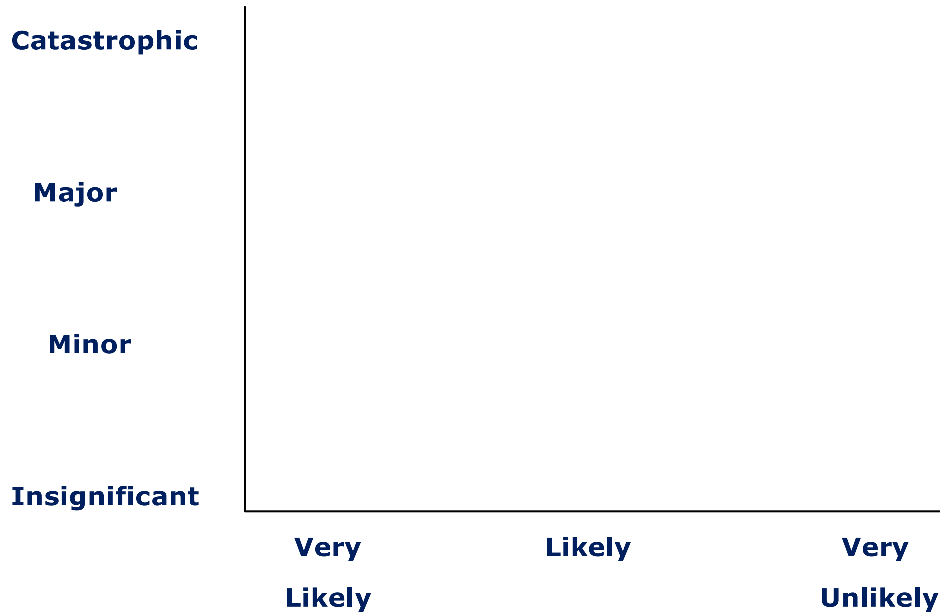
The ability of the company to respond to threats will be another major factor in deciding whether to accept or reject strategies that lead to potential risks. Risk aptitude relates to the asset capability of the organisation. The finance available and the technologies it can use to deal with potential environmental disaster should remote probabilities actually materialise into a risk event.

Risk roles

The expertise and independence of risk management is important. The willingness of market traders in financial services to accept risk for the promise of personal financial reward needs to be qualified or dampened by a risk committee that is willing and able to counter this cultural driver by applying limits to the degree of risk that is acceptable in trades, particularly in areas such as futures markets.

Risk mapping

Potential Impact of Risk



Risk Mapping is a formal tool or technique central to risk assessment. It evaluates each threat across two dimensions.

The potential impact on the organisation is assessed to identify the depth of exposure to the threat. Impact may require the use of experts to consider the consequence of a negative event or the use of computer based modelling to view the potential outcome. Probabilities are also used to determine the likelihood of the threat materialising over time. Statistics may exist to provide firm foundation for assessing exposure.

The combination of impact and probability provides a coordinate for plotting the threat on the risk map and, having determined its position, the risk map points the board towards the nature of strategy required to deal with the risk.

Objective and subjective risk

The approach taken to risk assessment utilising risk mapping will always include objective and subjective elements.

Objectivity suggests tangibility in methods used, a sense of assurance in the formality of approach or the sense of certainty that is perceived through the use of empirical evidence, statistics, computer based modelling or previous validated research by industry specialists.

Subjectivity relates to an opinion that is only objective or truth in the mind of the individual. It is a personal perception or belief, in this case regarding potential impact or probability of an event materialising. The risk attitude of the board establishes the subjective view and through this determines strategic responses to hazards.

Objective or factual risk assessment is either accepted or not by the beliefs of management. The potential impact of a threat materialising may be catastrophic, the probability may be very high but the board may decide not to act, either because it cannot due to finance pressure or because in its opinion a probability is a chance of something happening or not happening and not happening on their watch is what they are hoping for.

RISK STRATEGY

Risk analysis is the first stage in risk management. Risk strategy will follow with the need to determine appropriate responses to the nature of threat identified. The exact nature of the strategy will be unique to the company and situation. However, one risk categorisation suggests that risk strategy can be evaluated and determined with reference to the mnemonic TARA.

Transfer

Risk transference relates to the possibility of passing risk exposure to a third party so reducing or eliminating the threat to the company. Typically transfer is associated with the use of insurance, transferring the negative potential impact of a threat onto the insurance company. More significantly, outsourcing decisions and the involvement of suppliers and contractors in company operations is an appropriate strategy for risk transference.

Avoidance

Transfer or risk onto an insurance company or the use of a supplier to carry out company activity may be perceived as a risk avoidance strategy. However, avoidance is more associated with the outright rejection of a project or strategy that creates a risk unacceptable to the board or shareholders. How unacceptable the strategy is and whether the appropriate response is avoidance will greatly depend on subjective assessment and risk attitude.

Reduction

The use of an insurance company generally only reduces risk exposure since insurance cover is always limited in some way. The use of a contractor also reduces risk but rarely removes any sense of corporate liability for services it pays for. However, risk reduction is normally associated with any action that might mitigate impact or reduce probability to some extent. In particular, the development of control systems throughout company operations would be influential in risk reduction.

Acceptance

The element of exposure beyond the willingness of an insurance company to cover identifies an element of risk acceptance in company policy. Suppliers may go out of business or may not be able to fulfil contracts. In this sense the company must also accept some risk in its activities. Beyond these examples, the very nature of life and corporate operations requires each individual and the company as a whole to accept some risk in what it does.

ALARP

Risk strategy is really something that occurs between avoidance and acceptance of risk. The continuum that operates between these two points sees an interplay of reduction and transference approaches.

Where, along the line between avoidance and acceptance, strategy plays out, depends in part on risk attitude. Greater acceptance of risk often leads to greater rewards. Greater avoidance of risk often leads to fewer rewards.

The concept of ALARP (As Low As is Reasonably Practicable) asks the board to consider how many activities or risks it considers acceptable, how may it will avoid and how high or low it is willing to push the remainder through investment in risk management. ALARP could be viewed as a tool or technique to focus the mind, it could also be simply a statement used to govern board deliberations, providing a sense of prevailing risk attitude.

Risk diversification

The business of being in business is risky. Entrepreneurial risk relates to this sense of risk. How much is accepted or rejected is up to the individual or corporation. One area within which business risk is prevalent and risk reduction possible at the strategic level is strategic diversification.

The board of directors must make decisions regarding to what extent product or market diversification is acceptable and how the resulting diversity can be managed in order to create the conditions for ALARP.

Embedding risk

Turnbull, in his return to governance in 2005, focused on moving beyond the reactive need for control systems towards the requirement for adequate risk management. Embedding control was important to Turnbull in 1999, by 2005 he believed embedding risk was of the same level of significance.

Embedding risk in culture

The board of directors, risk committee and risk managers must all strive to ensure that, through leadership and strong communication, appropriate belief systems are created and sustained amongst staff with regard to the significant areas of risk that the corporation and they are exposed to. A strong belief in safety as a key risk area is often associated with embedding risk in culture.

Embedding risk in systems

To build risk management into the systems or technologies of the organisation has a two-fold meaning.

- First, it suggests the need for proactive investment in systems so that their technologies are reliable and fully functional so as to deliver required results consistently into the future.
- Second, such system must be monitored through the development of control systems coupled with appropriate reporting on system operation and output.

GOVERNANCE STANDARDS FOR RISK

Risk Management is the most recent addition to governance requirements for listed companies. Its importance has been dramatically heightened through reflection on the circumstances and conditions that led to the credit crunch of 2007.

However, because of its limited practical history in the market place and, still, limited acceptance outside of corporations that would have always had a natural tendency to recognise it (oil companies, banks, aircraft manufacturers etc), it could be argued that there is very little in the way of practical advice as to what standards to use in a risk management approach.

ERM

Enterprise Risk Management is the singular existing model for risk management on the global stage. It was developed in 2004 by the COSO committee predating Turnbull's defection from control to risk by a year.

ERM is a staged model within which appropriate tools and techniques can be utilised in order to provide a comprehensive approach to risk management.

1. Create a control environment

In this instance this would relate to the creation of a risk committee.

2. Set corporate objectives

This provides focus for what must be achieved and therefore the extent of risk acceptance.

3. Identify risk

These risks could relate to the strategic and operational levels although the model suggests the former.

4. Risk assessment

There is no standard for any given stage although risk mapping is a very common technique here.

5. Risk response

A variety of risk responses are necessary in order to deal with the variety of threats and the results of the risk assessment.

6. Create control activities

The latter stages in the model are designed to ensure risk strategies are implemented effectively. Control systems are developed to monitor strategic success.

7. Coordinate through information and communication

Reporting systems link the operational and strategic levels as part of the monitoring process.

8. Monitoring

In accordance with the original COSO framework, monitoring relates to the work of auditors in evaluating success and recommending adaptation of approach as necessary.

Risk audit

The final stage of ERM restates the importance of the audit function. The role of internal audit in a specific risk capacity is, like ERM and risk management itself, a very modern concept.

A possible view of the role might include a restatement of auditor functions in audit testing:

- To identify controls
- To investigate their use and effectiveness
- To report and recommend change.

The development of the role to embrace risk must also be included:

- To identify new risks
- To evaluate exposure to risks
- To evaluate success or suitability of current risk strategy
- To report and recommend change.

PAST PAPER ANALYSIS

December 2012

1 (b) Describe risk diversification and its difficulties (10 marks)

June 2012

1 (a) Explain different risk appetites. (6 marks)

December 2011

1 (c) (ii) Objective and subjective risk. (8 marks)

(iv) ALARP. (4 marks)

3 (b) Market risk evaluated. (10 marks)

June 2011

2 (a) The nature of dynamic risk. (8 marks)

(b) TARA strategies. (6 marks)

(c) Correlation of related risks. (5 marks)

(d) Describe culture of risk awareness. (6 marks)

December 2010

4 (b) Define risk embedded and how to do it. (7 marks)

(c) Examine the obstacles to doing it. (8 marks)

June 2010

1 (d) Why risk assessment is necessary. (8 marks)

December 2009

4 (a) Explain what embedding risk means. (6 marks)

(b) Assess governance ability to embed risk. (8 marks)

(c) Examine risk audit and its importance. (11 marks)

June 2009

4	(b)	Risk assessment framework.	(6 marks)
	(c)	Explain entrepreneurial risk.	(4 marks)

December 2008

2	(b)	Describe TARA strategies.	(10 marks)

June 2008

1	(b)	Describe a risk management framework.	(6 marks)
	(c)	Assess 3 project risks.	(9 marks)

December 2007

2	(a)	Four risk strategies and three specific risks.	(12 marks)
	(b)	Risk embedded in culture,	(5 marks)

June 2007

Chapter 12

Ethical theory and professionalism

ACCA STUDY GUIDE REFERENCES

- Explain relativism and absolutism
- Describe and distinguish between teleological and deontological
- Explain Kohlberg's stages of moral development
- Describe Grey, Owen and Adams 7 positions on social responsibility
- Describe and evaluate corporate and personal ethical stance
- Analyse the cultural context of ethics and CSR
- Explain and explore profession and professionalism
- Describe and assess what is meant by public interest
- Analyse the role of the accountant as a profession
- Recognise accountings role as a value laden profession
- Critically evaluate accounting as acting in the public interest

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ETHICAL THEORY

Ethical studies are an examination of morality, an investigation into the nature of right or wrong in any given situation. The situation could range from personal morality minefields such as acceptance of gifts or personal relationships in a professional context, through to corporate positioning regarding regime support, child labour or the environment. Whether a given personal or corporate position is right or wrong is wholly an individual concern. What a person believes is up to the individual, a unique and personal mindset.

The study of ethics investigates and evaluates this mindset. It seeks to challenge stance by illuminating alternative and conflicting beliefs that may serve to shift an entrenched position or enable individuals to better understand and accept the actions of others.

The International Federation of Accountants requires all accountants to be exposed to the ethical question, to better understand the challenges it creates and, through this, to be better able to respond to situations that may arise in their professional lives.

Absolutism and relativism

In order to discuss the variety of viewpoints that exist with regard to right and wrong ethical stances a spectrum between absolute and relative beliefs is created. The distance between the two extreme positions sees a movement from rigidity to flexibility in belief. Absolutism is a rigid belief system whereas relativism is an adaptable belief depending on situation context.

Characteristics of absolutism

- Set of principles which are non-negotiable
- Principle have universal application
- Principles are timeless in their application
- Creates a restrictive view and clear distinction between right and wrong
- A traditional view of morality.

Characteristics of relativism

- Offers guidance rather than rules for behaviour
- Flexible models dependent on the situation
- Responsive and adaptable to change
- Suggests improvement in ethical behaviour over time
- A modern, corporate view of morality.

Teleological and deontological

Absolutist beliefs incorporate teleological and deontological ethical motivations. The reason for a position with regard to right or wrong often includes influences from both and an evaluation as to why a person behaves in the way that they do would include identification of a variety of potential sources of action drawn from within these two concepts.

Teleological beliefs

Teleological is also referred to as consequentialism. The individual uses an evaluation of the potential outcome of a decision as a basis for determining their standpoint. Prior to making a decision they think about the future ramifications of deciding to act in a given way. Depending on their consequentialist beliefs these ramifications may or may not be acceptable to them. There are two kinds of consequentialist belief.

Egoism is a belief that the right decision is the one that leads to the maximum personal benefit. The decision is made by looking at the possible outcome of a situation and deciding whether it is in the individuals self interest to act in a certain way. This is a selfish standpoint.

Utilitarianism considers the likely consequence of behaviour in relation to the benefit for others. The impact of the decision is considered in relation to a variety of stakeholders and how actions may positively or negatively affect them. This is a selfless standpoint.

Both standpoints are influential although one will tend to dominate.

Egoistic beliefs and utilitarianism could be said to be the basis for societal decisions as well as individual decisions. At this level egoism or acting in self interest is the ethical foundation prevalent in western cultures and in particular capitalism. Utilitarianism or self sacrifice for the wider good is more commonly associated with eastern cultures or socialism as a political or societal belief system.

Deontological beliefs

Deontological beliefs are also referred to as non consequentialist beliefs. There is no consideration of what may happen either to oneself or others in making the decision as to how to act. The motivation stems from a sense of duty, a deep and automatic response to a given situation based on recognition of the perceived requirements of society. In this sense deontological is a better example of absolutism suggesting fixed non negotiable standards that influence actions.

The nature of duty may derive from a variety of sources:

- Obeying the law
- Upholding an individual's human rights
- Acting to a standard expected by family or community
- Acting to a standard expected by the individuals country
- Acting to a standard expected by an individual's religion.

Immanuel Kant suggested three factors that determined a sense of duty in his Categorical Imperative framework:

- The impact on society if everyone adopted the proposed position
- The impact on any individuals human rights if the proposed position is adopted
- The likely outcome if one's action become known by others.

ETHICAL STANCE

Relativism provides a much more modern context for the ethical decision. This school of thought was developed in the 1990s as a response to the increasingly global nature of business operations and the subsequent need to adapt rigid ethical beliefs to take into account local culture and cultural sensitivities.

Advice for the multinational includes:

- Create a corporate code of ethics
- Ensure individual subordination to the code
- Follow local examples rather than rigid principles
- Think local, act local
- Be adaptive and develop ethics over time.

To develop an appropriate ethical position or stance, two models can be used to assist.

Kohlberg's model

Kohlberg's Cognitive Moral Development model (CMD) investigates and maps a variety of ethical positions or stance that an individual may take with regard to any ethical decision. Since it is a development model the presumption is that the individual will strive over time to raise their ethical position to one that is at least in conformance with societal expectation.

The model has three stages and six positions:

1. Pre-conventional behaviour

This is below the level expected of the individual by society. Ethical belief is dominated by self interest and only this is only compromised to the extent that the actions of others may negatively affect the persons own interests.

(a) Obedience and punishment

The individual acts out of self interest only compromised by the perceived negative impact of others actions should they act in a certain way. The punishment aspect usually relates to the threat of action if a legal standard is not met.

(b) Instrumental Purpose and Exchange

This is also termed Instrumental ethics or an Instrumental stance regarding stakeholder relationships. The individual is willing to act in others interests or to meet others needs in as much as it helps to serve their own self interests. In stakeholder theory (Chapter 1) this is termed Enlightened Self Interest.

2. Conventional behaviour

This meets the requirements of society as an ethical position or stance. The requirement does not tend to be imposed or enshrined in law and so freedom exists as to whether the individual rises to this level of ethics. This is also termed a Normative approach to ethics.

(a) Mutual Expectation

The nature of societal expectation has a limited scope in its meaning. The nature of society may only extend to the standard expected of others within the individual's peer group or the company's own standard.

(b) Social Accord

The acceptance of standards broadens to those determined by the general public or country. Where mutual expectation ends and social accord begins is an unknown.

3. Post conventional belief

The individual rises above the expectation of society in terms of their ethical behaviour. How far above they go or how much this behaviour is consistently applied and affects all aspects of their lives creates the distinction between the sub categories.

(a) Social Contract

The contract is a personal belief that in as much as society has given the individual benefits during their lives so they should give something back to society. This may take the form of personal voluntary actions to assist in charitable works.

(b) Universal Principle

The self sacrifice associated with this level is taken to an extreme so that it dominates the entire lifestyle of the individual marking them out as someone who operates at a very high level of morality.

Kolhberg had a deep concern that accountants as a professional group were captured by capitalism and that their ethical stance often failed to live up to the standard expected by society. Training in ethics was deemed to be an appropriate response to this concern.

The model of Grey, Owen and Adams

Grey, Owen and Adams offer advice to the corporation rather than the individual with regard to its ethical positioning or stance. In their 7 positions on organisational social responsibility (1996) they offer a snapshot of different organisational beliefs without suggesting movement between stages or progression along the spectrum being required. This is because, beyond a certain point, some organisations are bound by their nature to exist exclusively at a given stage. As with Kohlberg, the spectrum moves from self interest through increasing degrees of self sacrifice.

1. Pristine capitalism

The corporation's beliefs are dominated by self interest with little or no regard to others. Adherence to the legal minimum typifies ethical decision making.

2. Expedient

The company exhibits a willingness to enter into dialogue with stakeholders and compromise its position in as much as profits are increased or not threatened by such action.

3. Social contractarian position

The company will meet a given level of expectation set by society simply because this expectation exists. The impact on profits is not considered. The ethical position is a price of existing in that society.

4. Social ecologist

The corporation rises above societal expectation to set new standards in ethics. The positioning would see the company strive to become an industry or global leader in CSR.

5. Socialist

The organisation or institution exists to meet a higher purpose than its own benefit. Its existence rests on the need to operate in the interests of society overall.

6. Radical feminist

The nurturing nature of femininity as opposed to overt masculinity is the basis for organisational activity. This is exemplified through humanitarian effort and charitable works.

7. Deep ecologist

Deep Ecology is anti institution, anti capitalist and anti corporation. The position of extreme ecological pressure groups promotes animal rights, environmental protection and a restructuring of society away from central government control and towards local community autonomy and simpler, less consumerism driven societies.

PROFESSIONALISM

The overriding ethical requirement for accountants is that they accept their role in society as a professional. A professional must meet a higher standard of ethical behaviour than other members of society in keeping with their perceived higher status.

The public perception of a profession and the subsequent degree to which society is supportive of the existence of certain roles as being professional in nature will depend upon the extent to which this higher standard is met.

Nature of a profession

Professionals such as lawyers, doctors, architects and accountants all share certain characteristics that mark them out as being a distinct group in society.

1. Special knowledge

In order to become a member of an esteemed profession the individual must accumulate a body of knowledge. This begins with the process of qualification and acceptance into the profession but must also embrace a willingness to continue their education throughout their professional lives, staying abreast of latest development and new ideas.

2. Special privilege

As a reward for going through the rigor of qualification, and as a motivation to do so, professionals are granted a privilege by society that is not available to those outside of the profession. In the case of accountants this relates to the privilege of passing judgement with regard to corporate position and prospects and to have an expectation that that judgement will be acted upon by those who have an interest in corporate operations. The limited availability of such a privilege supports the career prospects of the professional and creates a standard of living that they can realistically aspire to.

3. Special responsibility

As a price for sustaining their privileged position, all professionals must uphold a higher ethical standard than that expected by other members of society. This is the same regardless of what profession the individual belongs to. It is also unequivocal in terms of the requirement to meet the standard. All professional must ensure that, in every endeavour they are involved in, they act in the public interest.

Public interest

It is a contentious issue as to the extent to which accountants do act in the public interest.

It is relatively straight forward to be supportive of the role of the accountant.

Accountants:

- Reduce the potential for accounting misstatement and corporate fraud
- Provide managers with information to support decisions
- Provide information to the markets and shareholders
- Provide assurance to the market regarding company operations
- Support capitalism and the economic societal gains of commerce.

However, there are arguments that call into question the extent to which their role is positive:

- Accountants are almost always implicated in major corporate failure and financial scandal
- Shareholders and markets are a very small element of society overall
- Profit driven decisions often act against the interest of other stakeholder groups.

The question as to whether accountants act in the public interest often very much depends on what is meant by public. In as much as this relates to all those coming to the market and involved in the stock exchanges of the world, there is no doubt that accountants are vital, central players, integral to the success of market operations.

In as much as the public are viewed in a less qualified and more conventional sense of being the general public it is more difficult to argue that accountants support or even relate to the wider masses in the same way that a doctor or lawyer is a central player in society working for the common good.

Value laden role

In order to reduce the controversy over whether accountants act or do not act in the public interest, Grey (of Grey, Owen and Adams), calls upon accountants to embrace a wider, more value laden role. He chooses the phrase "value laden" as opposed to "enhanced role" or "improved role" because the traditional view of accountants is that they are value laden in the sense of being burdened by values or weighed down by the public need for them to be ethical in their behaviour. This weight, being too much to bear, leads to accountants acting in ethically questionable ways.

In his modern view of the term, Grey asks the accountant to add values or ethics to their role, again being weighed down, but this time being willing players in raising the extent to which ethical behaviour is central to their role.

In order to do this, accountants might:

- Focus more on environmental reporting
- Identify methods of incorporating environmental cost into business decision models
- Enhance the quality of community reporting and incorporating community costs and benefits into decision models.

Grey suggests accountants are well placed to do this given that they are already the major generators of information for management. The more that accountants focus on these issues, the more society's perception of accountants will improve and the less their role will be called into question as to whether or not they act in the public interest.

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December 2012

1 (c) Criticise professional and ethical behaviour in the scenario. (9 marks)

June 2012

No references

December 2011

4 (b) Describe stages in the model of Grey, Owen and Adams. (6 marks)

June 2011

1 (b) Describe Kohlberg's levels of moral development. (12 marks)

(d) (ii) Pristine capitalist perspective defence of a position. (6 marks)

4 (b) Discuss acting in the public interest. (10 marks)

December 2010

1 (b) Explain absolutist and relativistic approaches. (10 marks)

June 2010

4 (b) Principles of a professional. (7 marks)

(c) Professional and ethical dilemmas. (8 marks)

December 2009

3 (b) Criticise ethical and professional behaviour. (10 marks)

(c) Critically evaluate ethical alternatives. (10 marks)

June 2009

1 (a) Explain Kohlberg's model and select levels. (12 marks)

2 (a) Explain public interest. (5 marks)

(c) Explain the role of the deep ecologists. (7 marks)

December 2008

4 (c) Assess beliefs using teleological and deontological perspectives. (9 marks)

June 2008

2 (d) Evaluate using absolutism and relativism. (6 marks)

December 2007

1 (b) Explain Kohlberg's 3 levels and their application. (12 marks)

4 (b) Explain the positions of Grey, Owen and Adams. (8 marks)

June 2007

1 (a) Normative and instrumental ethics. (8 marks)

(b) Kohlberg and moral development explained. (4 marks)

3 (c) Discuss deontological and consequentialist ethics. (6 marks)

Chapter 13

Ethical decision making and the environment

ACCA STUDY GUIDE REFERENCES

- Explore issues surrounding the use of corporate codes of ethics
- Assess the principles of the IFAC code of ethics
- Describe issues associated with conflict of interest
- Describe and discuss rules and principle based approaches
- Evaluate the nature of ethical threats and safeguards
- Apply the AAA model for ethical decision making
- Apply Tuckers model for ethical decision making
- Explain Kohlberg's model for ethical decision making
- Discuss the issue of environmental footprint
- Explain the nature of environmental audit
- Describe the features of ISO14001 and EMAS
- Explore the concept of sustainability
- Explore accounting for the environment

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CODES OF ETHICS

Relativism relates to the development of ethical guidelines for the modern era. It assumes an increasingly global nature in business operations, supported through faster communications, creating a greater sense of interconnectedness between different societies.

In such a world, accountants must continually adapt to different norms and behaviours prevalent in different cultures. At the same time, the organisation must ensure all members of staff understand their position as representatives of the corporation and are willing to meet the demands of strict codes of conduct in their business relationships in line with organisational needs.

Codes of Ethics at a corporate and a professional level are a mechanism through which improved behaviour can be sought and consistency created for the benefit of all stakeholders involved in business operations.

Corporate codes of ethics

The growth in importance and use of corporate code of ethics can be seen in relation to the growth of relativism as a school of ethical thought. In a multinational environment corporate codes of ethics offer a number of benefits to the corporation:

- They convey a sense of strategic leadership
- They communicate key strategic values and beliefs
- They require staff to adapt to these standards creating a consistent ethical stance
- They improve company ethics
- They provide a benchmark for assessing ethical behaviour in the company.

Since ethics is a human issue, the content of a corporate code of ethics will naturally relate to relationships between the company and stakeholder groups.

Content will include:

- Statement of mission and values
- Employee rights and responsibilities
- Customer service policies
- Supplier relationships and policies
- Community relationships
- Environmental promises and policies
- Shareholder obligations and policies.

Corporate codes of ethics have a mixed track record of success. Generally, the need for such codes is accepted and support exists for their content. However, scepticism over their true worth as a mechanism for change remains.

This is, in part, due to the general scepticism over a board’s ability to see anything beyond the corporate bottom line and their own remuneration. In addition, criticism is often attached to such codes purely because of problems in their implementation rather than their inherent worth.

Advice for effective implementation might include:

- The need for strong strategic support of the code
- The need for appropriate structure and focused content
- The need for training in code related issues
- The need for continuous communication of worth
- The need to audit the codes use
- The need for forceful sanctions against misuse or code transgression.

IFAC's code of ethics

In 2005, the IFAC introduced a code of ethics that would govern accountants' decision making across the world. The code requires the accountant to ensure five principles are used as the ethical foundation for any decision:

Integrity

In line with the underlying concepts of governance, integrity is a vital issue for accountants just as it is for all members of the board of directors. Integrity suggests core characteristics of fairness, justice, decency and responsibility that are unshakeable in the mind of the accountant and beyond compromise, regardless of external influence or pressure.

Objectivity

Remaining focused on the goal of presenting a true and fair view of corporate financial position requires the accountant to remain detached or independent of the company and any undue influences. The threats to independence must be recognised and dealt with by the individual or audit firm. The threats are:

- Self Interest
- Self Review
- Familiarity
- Intimidation
- Advocacy.

These were discussed in chapter 9.

Professional competence and care

This principle reflects on a fundamental characteristic of a profession. The accountant must be fully qualified and once qualified ensure that they embrace Continued Professional Development so as to keep their skills up-to-date and relevant to the task in hand. This seems particularly important in areas such as tax law and the changing nature of accounting standards.

Confidentiality

The IFAC code of ethics has application to all accountants. This includes those who operate as employees within corporations as well as those that audit those corporations. Confidentiality therefore has application for accountants in their position as employees but also, possibly more relevantly, with regard to their relationship as auditors.

Professional behaviour

It could be argued that professional behaviour is merely a restatement, summary or conclusion to the code that incorporates the other four principles. However, this would fail to communicate anything else of significance and therefore the concept of professional behaviour must have a separate, distinct and meaningful definition. In reality it reminds the accountant of their overriding purpose as a professional in society. To behave as a professional is to act in the public interest.

Ethical safeguards

The accountant is particularly fortunate as a professional in having a large number of safeguards available to them that limit their exposure to the ethical question. By simply doing their job as they are trained to do and using or relying on the procedures and policies available to them, accountants, to a degree, avoid the need to become embroiled in considering morality and thorny issues that may arise through its examination.

Safeguards include:

- Recourse to the legal system
- Use of accounting standards
- Use of audit standards
- Use of governance standards
- Use of company policies and procedures
- Accepting limited hierarchical responsibility for ones actions.

ETHICAL DECISION MAKING

The use of a multitude of decision making safeguards or tools leads to the accusation that accountants are ethically rule driven in their approach to decision making. This is a reliance on standard procedure to the detriment of consideration of more fundamental principle driven concerns such as integrity, fairness, objectivity and general professionalism.

In most circumstances that the accountant has to consider on a day to day basis, being rule driven is not a problem, in fact it is the nature of the job. It is only in exceptional conditions that such an approach to decision making is wholly inadequate. The concern for the IFAC is that these exceptional circumstances tend to be events where inappropriate decision making leads to:

- Corporate fraud
- Massive financial misstatement
- Multinational corporation collapse
- Bankruptcy of societal institutions
- Events that bring accountancy into ill repute.

It is with regard to these high impact decisions that the IFAC recommends a measured approach to the decision that includes the use of one or more decision models to assist.

AAA model

The American Accounting Association model for ethical decision making is recommended by Sarbanes-Oxley 2002 as an appropriate tool that leverages a principle driven approach from a rules driven (staged procedures) model. The accountant simply works through the stages to investigate the issue and ultimately determine an ethically sound course of action.

1. Gather the facts

A formal fact finding exercise to independently verify the circumstances leading up to the ethical event.

2. Identify the nature of ethical issues

The circumstances and the emerging ethical event will identify a question of right or wrong that needs to be addressed. The ethical issue is often posed as a question that must be answered.

3. Identify ethical norms or principles

To address the ethical question there needs to be a foundation of principles that can be used a guide. The IFAC code of ethics seems appropriate for most circumstances.

4. Identify alternative courses of action

The ethical event is a moment in time. The company will always be moving forward and so there are a number of paths down which the company can head into the future. Each alternative will suggest a different answer to the ethical question and will support or ignore certain principles.

5. Evaluate actions using norms

The decision making process asks for each potential action to be considered with regard to the extent to which it supports the IFAC code of ethics.

6. Identify the consequences

Identifying the consequences after the evaluation of actions against norms may suggest a relegation of the importance of self interest or even stakeholder interest in the eyes of the IFAC. In the end the decision is the one that supports the credentials of the governing body or the overall public interest. Any amount of self sacrifice is a price worth paying in the public interest.

7. Make the decision

The final step is to take appropriate action. Not taking any action is an action in its own right and may in itself be considered appropriate depending on the circumstances.

Tucker's model

Tucker has a deep interest in social responsibility and in training managers to operate more ethically in the execution of their duties. His model includes a recognition that this primary duty is towards shareholders and their financial needs. This focus is then expanded to include wider ethical principles. He offers no advice as to the relative importance of each issue, leaving it to the individual to decide on how much weight they give to each area.

1. Profit

The accountant must reflect on the financial implications of any decision made, commercial or ethical.

2. Legal

Operating within the legal standard that exists should be a deontological duty rather than an issue that is open to compromise.

3. Fair

The decision must consider the extent to which the outcome is fair to differing stakeholders impacted upon by the decision. Fairness, as an underlying governance principle is about being even handed and just in decisions.

4. Right

Whether the decision is right or not is really the whole point of the ethical decision. It is of course a very deep and difficult issue. A sense of duty or self preservation may decide the outcome of this issue.

5. Environmentally sound

Tucker manages to include specific concern for the planet and its ecology as a decision element. It could be argued, since no advice is given, that this concern sits on the same level as profit in the mind of the decision maker, lifting the environment to become a key factor in the decision.

Kohlberg's model

Professor Kohlberg offers his own advice on a formal process for decision making. This seems reasonable given that he would like accountants to rise to at least the conventional level in their decisions. This being the case, the accountant must demonstrate through a formal process that they have taken into account the needs or ethical standards required by society.

1. Recognise the moral issue

This reflects the first two stages of the AAA model in terms of gathering the facts and, from this, identifying the moral question.

2. Establish the moral intent

The moral intent will be the ethical standard that must be sustained or achieved through the accountant's actions. In this case it is the IFAC code of ethics principles.

3. Make a moral judgement

Presumably the moral judgement will arise from an evaluation of principles against potential actions available in much the same process as described in the AAA model.

4. Engage in moral behaviour

This final stage relates to the importance of seeing the decision through. Of actually implementing whatever the accountant has decided upon, of walking the walk as well as talking the talk in terms of ethical behaviour. It is very easy to know what to do, it is something quite different to actually do it.

THE ENVIRONMENT

One aspect of corporate social responsibility is concern over the organisations impact on the environment and the extent to which policy can be developed to better manage that impact.

The benefits of developing such a policy include:

- Improved public perception
- Improved customer support
- Improved shareholder support and investment
- Ability to incorporate into marketing effort
- Positive environmental outcomes.

Appreciating that such a policy can positively benefit the company seems self evident. The difficulty is in translating this general need into a practical statement of position and future goals with a clear strategy to get from one position to the other.

Scope of environmental policy

The Coalition of Environmentally Responsible Economies (CERES) offers one set of standards within which policy can be defined. The credibility of CERES lies in the fact that it has been used by corporations successfully for over 20 years and because it derives from an international governmental agreement signed by over 50 countries. In terms of corporate governance it therefore provides a sense of being a global standard.

CERES asks the corporation to develop policy across a number of areas:

1. Energy usage reduction
2. Use of renewable energies
3. Waste reduction in processes
4. Appropriate waste disposal policy
5. Biosphere protection
6. Environmental restoration
7. Sustainability
8. Employee safety policy
9. Safety in company product design
10. Policy on community relationships.

Environmental audit

CERES is the foundation for a strategy and the success of the strategy is evaluated through an environmental audit carried out by internal auditors, external auditors or specialist consultants.

Such an audit would include:

1. Agreeing and establishing metrics.

The scope of metrics can be determined with regard to relevant CERES standards. Within each area a measurable target must be established for achievement over the future period.

2. Measuring performance against the standard

The control activities of collecting feedback on a level of activity and comparing it to the applicable target is a part of any audit.

3. Reporting compliance or variation

The audit committee provide a suitable strategic authority for managing the environmental audit. The need to take remedial action as necessary is inherent within this final stage.

This process is better supported if advice is provided as to how to establish metrics and which tools and techniques could be used to monitor and assess performance. This advice often takes the form of adopting methodologies used within formal accreditation schemes.

ISO 14001

The International Standards Organisation supports the use of CERES standards. The global accreditation scheme provides suitable credibility and recognition for those involved in multinational operations. It is a less exacting scheme allowing for internal audit and optional disclosure of audit findings to shareholders and stakeholders.

Eco management and audit scheme (EMAS)

This European accreditation scheme has by nature less appeal to those operating across the globe. It requires CERES to be used and emphasises the need for external rather than internal audit as a validation of organisational progress towards strategic goals.

Sustainability

In 1983, the Bruntland Commission defined sustainability as:

"the ability to meet today's needs without sacrificing those of future generations"

The difficulty lies in firstly determining what today's needs are and what future generations needs might be. Even if it were possible to make these issues tangible, the challenge is then in deciding how the requirements of meeting today's needs might be met without overt negative impact on planetary needs in the future.

Although the definition offers little beyond a vague sense of sustainability as a concept, most people would agree that it does embrace concepts of environmental footprint and self sufficiency.

Environmental footprint

The concept of footprint has more than a passing reference to fossilised dinosaur tracks etched into rocks on a mountain ridge. It relates to what we leave behind after we are gone, the evidence of our existence on the planet. Like the dinosaur remains, the belief is that this residue of our passing should be as small as possible so as to leave the earth in a similar state for future generations to enjoy.

Self sufficiency

The minimisation of the footprint suggests the need to exist within tight constraints during our time on the earth. Zero footprint arises through the ability to consume only what we produce, to be self-sufficient in our lives.

Difficulties

Both concepts seem difficult to translate into practical policies that may form part of strategy and be audited through accreditation schemes.

Grey and Bebbington argue that the value laden role of the accountant should rise to this challenge and include a number of accounting techniques that may move the corporation towards reducing its environmental footprint:

Impact accounting

This is an output driven analysis of company impact on the environment.

Flow Accounting

Building on impact accounting, the focus broadens to look at the nature and cost of inputs and how efficiently they are absorbed or used by the organisation. The goal is to reduce the inputs or transfer them into using renewable sources. Efficiency improvements reduce input use over time.

Full cost accounting

The full cost of company existence and operation would include the results of flow accounting and impact accounting. This is then extended to include not just environmental but also social impact in terms of the impact on the quality of lives of stakeholders impacted upon by operations. The combination of the two investigations then sit alongside the traditional financial reports produced by the accountant to create a triple bottom line analysis:

- Economic or financial report
- Social report
- Environmental report

This is not to suggest that the latter two reports are of the same scope and depth as current financial statements. Their existence does however provide clear evidence of corporate concern for the environment and offers the accountant an opportunity to demonstrate their professional role in acting in the public interest.

PAST PAPER ANALYSIS

December 2012

1 (a) Describe social footprint and its negative implications (10 marks)

4 (a) Use Tuckers model to assist in decision making. (10 marks)

June 2012

1 (b) Use the AAA model for decision making. (14 marks)

3 (b) Describe four ethical safeguards. (8 marks)

December 2011

1 (a) Purpose and evaluation of a code of ethics. (10 marks)

June 2011

4 (a) Describe the five ethical threats. (9 marks)

December 2010

2 (a) Explain and criticise approach to sustainability. (6 marks)

(b) Explain the stages of an environmental audit and issues involved. (9 marks)

June 2010

1 (e) Explain environmental footprint. (6 marks)

December 2009

1 (a) AAA model for ethical decision making. (14 marks)

June 2009

2 (b) Explain five types of ethical threat. (5 marks)

(c) Assess the ethical threats implied by beliefs. (8 marks)

December 2008

1 (a) Assess secrecy option using Tucker. (10 marks)

4 (a) Describe purpose and content of a corporate code of ethics. (9 marks)

(b) How can it be used to improve corporate positioning. (7 marks)

June 2008

1 (d) Define sustainable development. (3 marks)

(e) Evaluate environmental and sustainable implications. (8 marks)

2 (b) Explain employee and professional duties. (6 marks)

(c) Explain tensions in these roles. (4 marks)

December 2007

June 2007

1 (e) Define environmental foot print. (8 marks)

3 (a) The benefits and problems of codes of ethics. (12 marks)

4 (c) Ethical responsibilities of the accountant as a professional. (7 marks)