London
School of Business
& Finance

powered by

InterActive

ACCA Paper P1

Governance, Risk & Ethics

Class Notes

June 2011

© The Accountancy College Ltd, January 2011

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior written permission of The Accountancy College Ltd.

Contents

		PAGE
INTRODUCTION TO THE PAPER		5
CHAPTER 1:	CORPORATE GOVERNANCE – AN INTRODUCTION	7
CHAPTER 2:	CORPORATE GOVERNANCE – MORE DETAILED AREAS	21
CHAPTER 3:	AGENCY THEORY AND TRANSACTION COST THEORY	29
CHAPTER 4:	GOVERNANCE IN DIFFERENT COUNTRIES AND ORGANISATIONS	35
CHAPTER 5:	RISK MANAGEMENT	49
CHAPTER 6:	INTERNAL CONTROL SYSTEMS	61
CHAPTER 7:	STAKEHOLDER THEORY AND CSR	69
CHAPTER 8:	BUSINESS ETHICS	81
CHAPTER 9:	THE PROFESSIONAL ACCOUNTANT	93

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 marks 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

Corporate governance – an introduction

EXAM STYLE QUESTIONS

- Explain the problems companies have suffered, that have resulted in the need for corporate governance regulations.
- Explain the agency problem and agency cost.
- Who sets corporate governance regulations?
- What are the key concepts that underpin corporate governance?
- For a given situation, identify the key concepts that are / are not being followed.
- What are the main areas that corporate governance covers?
- Explain the business argument for and against corporate governance.

CHAPTER CONTENTS

A BRIEF HISTORY OF UK COMPANIES ---------------------------------- 9

The South Sea Bubble 9

The 20th century 10

More recent problems 11

WHAT IS CORPORATE GOVERNANCE? --------------------------------- 13

The agency problem 13

CORPORATE GOVERNANCE RULES / GUIDANCE ---------------------- 14

Who sets the rules? 14

Underlying concepts behind corporate governance 14

THE MAIN AREAS OF CORPORATE GOVERNANCE -------------------- 16

Directors 16

Chairman and Chief Executive Officer (CEO) 16

Board balance 16

Appointments to the board 17

Annual performance review 17

Re-election of board members 17

Remuneration of directors 17

Remuneration committee 17

Financial reporting 18

Internal control 18

Audit committee and audit 18

Relations with shareholders 18

Constructive use of AGM 18

Institutional shareholders 18

THE BUSINESS CASE FOR CORPORATE GOVERNANCE --------------- 19

For 19

Against 19

Conclusion 19

A BRIEF HISTORY OF UK COMPANIES

The South Sea Bubble

- In 1711, the South Sea Company was granted exclusive trading rights in the South Seas (South American colonies) in return for helping to finance Government borrowing.
- To help grow their operations, they looked for investors and issued shares.
- Things seemed to be going well – more and more investors put money in.
- There were expensive London offices – it all looked very successful.
- Management lied about how good it was – with no information available other than what management told them, investors did not know the truth.
- In 1718, Britain and Spain went to war … and the ability to trade in the South Seas was now zero. A shame, as the company had only sent its first trading ship in 1717.
- But investors did not know this and kept buying shares, largely because management (and some politicians who owned shares) kept making positive comments about the company …..
- …..whilst management secretly sold their own shares.
- Once the truth got out, there was a crash – the "**South Sea Bubble**" had burst. Many had bought shares with loans and could not repay them, leading to personal bankruptcies (and some banks also went bust as they could not collect the loans).

What can we learn from this?

- Investors need to be able to trust managers / directors.
- Directors have all the information.
- Investors need to be provided with complete, accurate information.
- But if the directors provide this information, they might lie!
- Directors may act to make themselves wealthy, not the investors.
- If management are selling shares, investors should be told – and be able to ask why!
- If one company collapses, it often leads to others collapsing as well

At the time, the UK Government reaction to this was the first "corporate governance" …

THEY BANNED LIMITED COMPANIES. ISSUING SHARES WAS ILLEGAL!!!

Eventually, this situation had to change. In the 19th Century, the growth of railways that needed investment, and the existence of limited companies in the USA, meant that the UK had little choice but to follow, and allow limited companies to exist again.

The 20th century

In 1932, two economists Bearle and Means made some observations about American companies:

- Shareholders were more likely to sell their shares than speak out if they thought directors were not running the company very well. This could result in poor quality management never losing their jobs.
- Some American companies were getting very **large**, and with so many shareholders there was a growing gap between those who **owned** the companies, and those who **controlled** them.

By the 1950s, companies were growing ever larger – what we now know as "**globalisation**" … the existence of large multinational companies with influence around the world was well under way.

The 1970s – 1990s saw problems starting to become common.

By the late 1980s, there were some famous corporate collapses – some due to poor management, but many due to fraud:

Polly Peck

- Rapid growth in the 1980s took this East End company to the FTSE 100.
- Run by Asil Nadir (who escaped to Northern Cyprus, but returned to UK in 2010 and will stand trial).
- Donated money to the Conservative Party (who were in power).
- In 1990, £700m found to be missing.
- Company placed into administration.

Maxwell

- Publishing and Newspaper empire (Daily Mirror).
- Seemed very successful.
- Run by Robert Maxwell.
- Donated money to Labour Party.
- In 1990 / 1991 company debts grew, and Maxwell used Pension Fund money to keep the companies from going bust.

Barings

- In early 1990s, traditional UK bank Barings expanded into "new" products – options and futures trading.
- Nick Leeson was given the new Singapore branch to manage.
- He had total control – he was the star trader, but also controlled the recording of these trades … no **segregation of duties**!
- When mistakes were made, he was able to hide them in a suspense account – his 88888 account.

- Then he started making illegal trades, partly to hide his own mistakes, and then in an attempt to make massive profits – the 88888 account became his hiding place for everything.
- Eventually he opened positions that left Barings heavily exposed if the Nikkei fell … and the Kobe Earthquake caused it to crash.
- With losses growing daily on positions he could not close … he ran away.
- Only then did Barings find out how bad the situation was, and it was too late to save the Bank … which was later to be sold for £1.

Common features of these examples?

- Too much control in the hands of 1 person.
- Nobody asking questions of this person.
- This person was the only one to know all the real information.
- Personal greed.
- Directors who failed in their duty to look after the company.
- Poor quality auditors who should have seen what was happening much earlier.

As we shall see shortly, these corporate failures caused the UK Government to act – and throughout the 1990s **corporate governance** grew in importance … but had enough been done?

More recent problems

Enron

- Successful US energy company, based in Houston, Texas.
- One of the top 10 companies in the US.
- Were using accounting techniques that were either illegal, or at least questionable, to hide the massive debts the company had.
- Enron were borrowing through "Special Purpose Entities" that they controlled, but that were NOT consolidated into Enron's figures.
- With much of the borrowing guaranteed against the value of Enron shares, all it needed was rumours of problems and the share price would start to fall …
- … leading to some of the borrowing needing to be repaid …
- … causing the share price to fall even more …
- … and the company collapsed in late 2001.
- Incredibly, this situation had many similarities to the previous UK examples:
- Poor quality auditing – Andersens, one of the top accountancy firms in the world, lost their reputation and collapsed as a result of Enron.
- Poor quality directors – those not involved in the fraud failed to understand what was going on, and failed to ask questions.
- Personal greed – leading Enron directors made millions from the way in which the special purpose entities were set up.

Clearly, companies / corporations need to be governed / regulated in some way.

Banking Crisis 2007-2010

- Banks had been lending to riskier and riskier people, especially for mortgages.
- Because banks trade these mortgage assets (they are receivables), the whole banking sector was involved.
- Many banks had taken big risks to expand, including taking over other banks at very high prices (Royal Bank of Scotland took over Dutch bank ABN-Amro, Lloyds took over Halifax Bank of Scotland).
- Northern Rock realised that defaults on loans were a major problem, and the rumours caused a "run" on the bank. The UK government stepped in to save it, and restore market confidence.
- But other banks were also in trouble, and the hidden truth started to become clear.
- In late 2008, Lehman Brothers collapsed, with the US government choosing not to rescue them.
- In the UK, RBS and Lloyds both had to be rescued by the UK government putting in billions of pounds and becoming the major shareholder.
- This has raised many questions about risk management, risk culture, remuneration (especially bonuses) and the way performance is measured in relation to risks being taken, the role of auditors and financial reporting etc.

WHAT IS CORPORATE GOVERNANCE?

- In many organisations, those **controlling** it are not the same people who **own** it.
- In the largest organisations, owners may have such **small individual stakes** that:
    - They do not care too much what the organisation does.
    - They are not prepared to challenge the directors.
    - They do not have the power to challenge the directors.
- The biggest owners are often **institutional shareholders** – for example, pension funds
    - They are investing money on behalf of others – it is not theirs.
    - They tend to be "inactive" by nature, preferring not to "rock the boat".
- **Globalisation** has resulted in the biggest companies / organisations becoming even larger than in the past – which is making the above issues even more important.
- Recent **corporate disasters** and the apparent increase in **corporate fraud** and **unethical business behaviour** have lead to a lack in trust in directors.

This all leads to the **AGENCY PROBLEM.**

The agency problem

In simple terms, if you want something done properly, the way you want it done … Do It Yourself!

Agents are people employed to do something for you (you are the "principal"). The risk is that they do it for themselves … rather than fulfilling their "fiduciary duties" to you.

Agency Costs

If you employ someone to do something for you, additional costs will arise:

- The agent will expect to be paid for their work
- The agent may expect additional benefits
- A nice office
- A company car
- To travel first class while doing your business
- You will have to spend some time and effort **monitoring** the agent to ensure they are doing what you want … and the less you trust the agent, the more checking you will want to do!

Corporate Governance is a system of laws or guidance aimed at making (or helping) directors manage companies in the best interests of shareholders, and potentially other stakeholders. Its objective is to create **effective, entrepreneurial and prudent management**, to deliver **long term success**.

In other words, it is an attempt to deal with the agency problem (conforming) with a view to maximising long term performance.

CORPORATE GOVERNANCE RULES / GUIDANCE

Who sets the rules?

- Global – the OECD have developed a Code (Organisation for Economic Co-operation and Development). The ICGN (International Corporate Governance Network) has used its membership to create its own more detailed guidelines built around the OECD Code, and designed for use by any country.
- National – many countries have developed their own systems, sometimes as laws (e.g. Sarbanes-Oxley in the USA) and sometimes as a Code (e.g. UK Corporate Governance Code (formerly called Combined Code)).
- Companies – many companies have tried to develop their own policies on Corporate Governance, some of which go further than the rules or Code their country expects them to follow.
- Other – in some countries, a regulatory body will set some rules. For example, something that appears to be "voluntary" can effectively become law (e.g. in UK all listed companies are required to either follow the UK Corporate Governance Code, or explain why they have not followed it – Stock Exchange Rules).

Underlying concepts behind corporate governance

These are the fundamentals behind how companies (and more importantly those involved with companies, primarily directors) should behave.

As we will see at the end of the course when we study business ethics, there remains some debate about the words "should behave"…

Fairness

All people affected by decisions (stakeholders) should be treated with equal consideration.

Openness / transparency

All information should be made available to stakeholders, and in a clear manner. This may suggest companies should not just follow disclosure rules, but also add **voluntary disclosures** if it adds to transparency.

Independence

All those in a position of **monitoring** should be independent of those / what they are monitoring:

- Non-Executive Directors should be independent of the Executives, and of company operations.
- External auditors should be independent of the company, especially its accounting department and processes.
- Internal auditors should be independent of the company, as they are likely to be involved in monitoring systems throughout the company's operations.

Probity / honesty

This is not just telling the truth – it also means finding out / investigating the truth, not ignoring it (not "turning a blind eye").

Responsibility

Directors should understand and accept their responsibility to shareholders and other stakeholders, and act in their best interests … and be willing to accept the consequences if they fail in this responsibility.

Accountability

This links with responsibility. Directors must be willing to be held to account (i.e. be judged) for their actions – and whilst **responsibilities** can be delegated down through the management structure, **accountability** comes with the job and cannot be passed to others.

Reputation

Directors must protect their own reputation, and that of the company they run, as damage to either is likely to lead to more widespread damage to the company.

This raises an interesting debate about whether a director's **private life** is in fact private – since a bad personal reputation is likely to affect their business reputation and hence that of the company.

Judgement

Directors must ensure they have all the necessary information and understanding in order to be able to make sensible business decisions that improve the prosperity of the company.

Integrity

This is quite a general term and has a crossover with some of the other terms above. Integrity means honesty, fair-dealing, presenting information without any attempt to bias opinion … and in a more general sense, "doing the right thing". It also links with words such as consistency, reliability, trust – and therefore integrity applies not just to people such as directors and auditors, but also to systems, financial reporting etc.

THE MAIN AREAS OF CORPORATE GOVERNANCE

Using the UK Corporate Governance Code as an example, the primary areas of Corporate Governance are as follows:

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.
- Include Non-Executive Directors (NEDs) who:
  - contribute to strategy, and challenge the Executives.
  - assess performance of the Executive Directors.
  - Oversee integrity of financial information, control systems, and risk management.
  - Decide remuneration of the Executive Directors.
  - Appoint, remove, and consider succession planning of Executive Directors.
- 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 NEDs meet without the Executives, to consider their performance.
- Should ensure NEDs meet (with SID leading) without Chairman annually, to consider the performance of the Chairman.

Chairman and Chief Executive Officer (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, aided by Company Secretary, should ensure adequate information flows between Board members, and in advance of Board meetings.
- Chairman is key contact for shareholders.
- Chairman is Independent on appointment.
- Chairman is not the former CEO of the company.
- CEO runs the company.

Board balance

- No one person, or group, should be able to dominate the Board.

- For the biggest companies (FTSE 350) at least ½ the Board, excluding the Chairman, should be Independent NEDs.
- Should be an appropriate size, and right balance of skills and experience. This includes diversity, including by gender.
- Annual Report must detail which NEDs are considered independent.
- Should appoint a Senior Independent Director – so shareholders (and board members) have an alternative to talking to the Chairman.

Appointments to the board

- Nomination Committee, majority of whom are Independent NEDs.
- Chaired by Chairman (unless Chairman is being discussed).
- Have objective merit-based criteria for selection of new Board members.
- Report its work in the Annual Report.
- Oversee induction and training for all directors (likely to be organised by Chairman, assisted by Company Secretary).

Annual performance review

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

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.

Remuneration of directors

- Enough to attract, retain and motivate.
- Significant proportion should be performance-related.
- Should consider industry pay levels.
- NED remuneration should not be performance-related, but should reflect time involvement of the role.
- If a director is removed before the end of contract, provisions should be in place to ensure they are not over-compensated for failure.
- Notice periods no longer than 1 year.

Remuneration committee

- At least 3 Independent NEDs as members.
- Should set remuneration of all executive directors and the chairman, and senior management.

- Remuneration of NEDs is flexible – could be by Board as a whole, by shareholders, or a separate Board Committee.
- Shareholders must approve any long term share options.

Financial reporting

- Board should present a balanced assessment of company's position and future prospects, its business model, its strategies, and that it is a going concern.

Internal control

- Board should ensure a sound system of Controls (more detail on this in **Chapter 6**).
- Annual review of effectiveness of Controls, and report this in Annual Report.

Audit committee and audit

- Audit Committee of at least 3 Independent NEDs (smaller companies = 2).
- At least 1 member to have recent relevant financial experience.
- Main role is liaison with the internal and external auditors on all matters (more detail on this in **Chapter 6**).

Relations with shareholders

- Regular dialogue with shareholders.
- Chairman to ensure shareholder views communicated to Board.

Constructive use of AGM

- Communicate with investors and encourage debate.
- Separate resolutions on each issue.
- Allow and monitor the use of proxy votes.

Institutional shareholders (UK Stewardship Code)

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

The update of The Combined Code in 2010 resulted in numerous changes (all of which are reflected in these course notes). There were 2 major concerns:

- That directors were following the "letter" of the Code rather than its "spirit".
- Better interaction was needed between directors and shareholders.

Regarding the second of these, it was agreed that the largest Institutional Shareholders should have their own code of governance, and that the UK Corporate Governance Code would focus on directors. As a result, the new UK Stewardship Code was created, to work alongside the UK Corporate Governance Code. There is more detail on this within Chapter 2.

THE BUSINESS CASE FOR CORPORATE GOVERNANCE

Corporate Governance differs between countries, but tends to be either law, or "best practice" which companies are generally expected to comply with.

But if it can be shown that improved corporate governance leads to increases in company profits and share price, any sensible Board of Directors would surely choose to have good corporate governance voluntarily … meaning there would be no need for regulation.

There are arguments both for and against this link being true:

For

- Good governance includes good risk management which must surely improve the performance of a company.
- Good governance creates a better impression of the company to investors, who are more likely to want to buy the shares and hence will drive up the share price.
- Happier investors are likely to require a lower rate of return on their investment, meaning company finance would be cheaper.
- A more balanced Board should reduce the risk of a single director defrauding the company.
- Some aspects of governance, e.g. corporate responsibility, may improve the company's reputation among its customers, and lead to products achieving a premium price, and sales volume increasing.

Against

- Governance means lots of new systems and monitoring to make sure there is compliance takes time and money.
- If investors feel companies are doing it purely to comply, they may not feel there are any major business benefits.
- The governance requirements are likely to need more directors, especially NEDs, to be employed – and senior staff are not cheap!
- Increased reporting responsibilities, and increased accounting complexity.

Conclusion

Real world evidence suggests very strongly that improved governance DOES lead to improved company valuation … and companies with poor governance get bad media reaction, complaints from investors, and their share price tends to suffer as a result.

Chapter 2

Corporate governance – more detailed areas

EXAM STYLE QUESTIONS

- Explain the role of directors in a company?
- What is meant by fiduciary duty?
- What are the main roles of Non-Executive Directors?
- Explain the importance of the independence of NEDs, and circumstances where their independence could be threatened?
- Explain the importance of succession planning for a Nomination Committee?
- Suggest some of the content of an induction programme for a new company director?
- Explain the importance of annual performance reviews for boards of directors, and how such a review could take place effectively?
- Discuss the main components of a director remuneration package, and how to ensure it is aligned with company interests?
- Explain the importance of institutional shareholders, and the circumstances in which they may intervene in a company?

CHAPTER CONTENTS

THE ROLE OF DIRECTORS-- 23

NON-EXECUTIVE DIRECTORS 23

INDEPENDENCE OF NEDS 24

THE CHAIRMAN AND CEO ROLES 24

THE NOMINATION COMMITTEE --- 25

INDUCTION OF NEW BOARD MEMBERS 25

BOARD OF DIRECTORS – PERFORMANCE REVIEW ------------------- 26

REMUNERATION OF DIRECTORS --------------------------------------- 27

INSTITUTIONAL SHAREHOLDERS-------------------------------------- 28

THE ROLE OF DIRECTORS

Directors have a **fiduciary duty,** meaning a position of **trust.**

Directors could, for example, use their position for personal gain (as any "agent" could).

Their fiduciary duty is:

- To disclose all information held.
- To disclose any personal profits made from their position as director.
- To disclose any potential conflicts of interest.

All directors should ensure they commit enough **TIME** to the job (e.g. other directorships should be kept to a sensible minimum).

Non-executive directors

A non-executive director, or NED for short, is not involved in day-to-day direction of the company, unlike the Executive Directors. The roles of the NEDS are:

- to contribute to company strategy (STRATEGY role)
- to monitor the performance of the Executives (SCRUTINY role)
- to monitor risk management and financial reporting (RISK role)
- to appoint, remove, and decide the remuneration of the executives (PEOPLE role).

Exercise

What are the advantages and disadvantages of NEDs?

Independence of NEDs

Anyone in a monitoring role needs to be independent of what they are monitoring. For NEDs this means having no connection with any part of the company:

- 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. Whilst there may be sensible business reasons for this, to promote links between 2 companies, it means that 2 directors are closely linked, and that both may favour one of the 2 companies over the other.
- Any NED who has been on a Board for >9 years is assumed to no longer be independent (and will be annually re-appointed after this).
- Any NED representing the views of a major shareholder would be deemed not to be independent.

If a director is not independent, it does NOT mean that they must leave the Board! It simply means that for Corporate Governance purposes, that director will not be considered an Independent NED … so an additional Independent NED may have to be added to ensure the correct balance.

Notice how similar the above rules are to those for external auditor independence, as seen in Paper F8 / 2.6.

The chairman and CEO roles

- Historically, many companies saw the promotion of a CEO to Chairman as the final promotion someone could get.
- In other companies, especially in the USA, the lead director would often be called Chairman & Chief Executive, as many companies preferred to have a single person in charge making decisions.

The modern view is that there should be NO links between the Chairman and CEO:

- Not the same person.
- The CEO of a company should not become Chairman. If the company uses "Comply or Explain" to deviate from this requirement, shareholders should be consulted in advance.
- There should not be other links between the 2 people (eg close family relationship).

By having 2 powerful people on a Board who are independent of each other, it should ensure that no one director is able to dominate the Board. The split of responsibilities should be set out in writing, and reported to shareholders.

THE NOMINATION COMMITTEE

- Role is to monitor the Board and Committees and ensure appropriate membership.
- Have to decide type of people needed to ensure balance and skills on the Board. Required role / capabilities should be agreed before searching.
- May use outside "executive search" agencies (headhunters) to approach potential candidates, especially where they should be independent (Chairman, NEDs).
- Roles of Committee should be disclosed in the Annual Report.

Succession planning

- Cannot just wait for a senior figure like a Chairman or CEO to announce they are leaving – even if they give a year's notice, any potential replacement may also have to give a year's notice!

Induction of new board members

Exercise

You are due to join the Board of P-MEK, a company listed on its country's Stock Exchange, in 2 months' time.

What could the company do to help you as you start your new role?

BOARD OF DIRECTORS – PERFORMANCE REVIEW

- At least once a year, the Chairman must organize an appraisal of (and act on the results of) the performance of:
  - The Board.
  - Each Board Committee.
  - Each individual Director.
- Many companies do this internally – although this creates some problems, as all of the directors end up appraising each other!
- As such, some companies use outside experts in the process, to try to make it more objective. FTSE 350 companies must use someone external (and report on how independent they are) at least every 3rd year.
- The method of evaluation should be disclosed in the Annual Report.

REMUNERATION OF DIRECTORS

As noted in Chapter 1, director remuneration needs to be:

- Enough to attract, retain and motivate directors
- But should not be excessive
- It must also be fully disclosed, with all detail, on a director by director basis in the Annual Report.

There are 5 key elements to a remuneration package for Executive Directors:

- SALARY – which will be based on similar salaries in the Industry, and at similar size companies, and on the skills and experience of the individual director.
- PENSION SCHEME CONTRIBUTIONS – which are typically a % of the base salary.
- BENEFITS – such as company car, travel expense allowances, health care etc. In some companies benefits may increase based on performance, but in many companies they are fixed.
- BONUS – typically based on annual performance measures, to motivate short term performance.
- LONG TERM SHARE OPTIONS – to motivate in the longer term. The more directors can drive up the share price, the more reward they will get.

The balance of this package needs careful thought, as there are plenty of potential problems:

- Salaries need to fit in with the salaries of others – including sub-board management.
- Benefits should ideally be company-related. Directors who travel a lot would be more likely to get a company car, for example. Directors who attend many public events may get a clothing allowance.
- The annual bonus could lead to manipulation of the Financial Statements, or a deliberate attempt to inflate short term profit (which may harm long term profit). It would be sensible to link the bonus to several challenging measures (and put a cap on it), and not just those that are aimed at financial results:
  - Profit
  - Market share
  - Growth
  - Reduction in staff turnover
  - Reduction in customer complaints
  - Reduction in pollution.
- Share Options, if very profitable, could result in a director retiring the moment they are exercised! Often directors will not be able to take all of their gains in one go, to try to tie them to the company for at least another year or two!
- Pay should be aligned with the level of risk taken, and "clawback" provisions should be considered.

INSTITUTIONAL SHAREHOLDERS

Traditionally, institutional shareholders (e.g. pension schemes) have been "conservative" by nature:

- They would often have such large amounts invested in companies, that they preferred to let the directors make short term mistakes, as long as they still trusted them in the long term.
- They would often allow directors to grant themselves large pay rises, because compared to their billion pound investment, a few extra million on a salary is immaterial.

With their shareholdings being large, and their votes therefore considerable, corporate governance regulations have tried to target institutional shareholders to encourage them to be more active, and to use their votes wisely.

If a Board is underperforming, one large shareholder could create change, whereas smaller shareholders may not have enough "weight" to achieve anything.

In recent years, institutional shareholders have indeed become much more active:

- Partly because corporate governance has encouraged them
- Partly because many have seen that improved governance leads to increased share prices
- Partly because those whose funds they are investing are putting more pressure on!

As noted in Chapter 1, there is now a **UK Stewardship Code** aimed at good governance of institutional investors. Its main principles are:

  - Public disclosure of how its responsibilities will be met
  - Robust policy on conflicts of interest
  - Investors should monitor companies they invest in
  - Policies on when to intervene (see below)
  - Investors should act together where appropriate
  - Investors should have clear policies on voting, and disclosure of how they voted
  - Investors should report periodically on their activities/responsibilities.

Institutional Shareholders are likely to intervene in a company if:

- Company is consistently under-performing
- Company's reputation is poor
- Directors are failing to communicate with shareholders
- They have lost faith / trust in the directors
- Company's strategy appears too risky / not risky enough
- Consistent failure in company systems
- Repeated fraud.

Chapter 3

Agency theory and transaction cost theory

EXAM STYLE QUESTIONS

- Explain the links between agency theory and transaction cost theory.

CHAPTER CONTENTS

AGENCY THEORY REVISITED -- 31

TRANSACTION COST THEORY --- 32

AGENCY THEORY AND TRANSACTION COST THEORY LINK --------- 34

AGENCY THEORY REVISITED

As we saw in Chapter 1, Agency relationships are caused when a **principal** employs someone (the **Agent**) to do something for them.

The potential problem is that the Agent may not act in the best interests of the principal:

- They might simply not perform the task to a high enough standard.
- They might perform the task for their own advantage.

A number of agency relationships involving accountants can exist:

- Shareholders employ Directors as agents to run companies for them.
- Shareholders employ Auditors as agents to check the truth and fairness of the published Financial Statements.

The potential for agency problems in companies has increased in recent years because:

- As companies have become larger / global, the gap between the directors and the shareholders has increased, increasing the chance that directors do not act in shareholder interests.
- Recent corporate disasters have reduced the level of trust in company directors.
- Even the largest shareholders have relatively small shareholdings, making it difficult for any shareholder to get enough support (in terms of % of votes) to achieve change.

TRANSACTION COST THEORY

In the 1930s, economist Ronald Coase was investigating the reasons why companies exist, and why they were growing so large.

Example

You have left your job, and have decided to run accountancy exam training courses on your own. You have identified 2 different ways of going about the organisation of your venture:

Option 1

You will either buy a property, or agree a 5-year lease. You have identified 6 tutors who could teach all of the exam papers between them, so you would offer each of them a full time job with salary, pension scheme, health care benefits. Each tutor would have a contract of employment with a 6-month notice period.

You have found a company who publish the text books and other course materials that you need. You would agree a 2-year supply deal with this company.

In each classroom, you will have installed computer and projection equipment which you would buy. You would also buy the necessary chairs and tables for students.

To help finance this plan, you will take out a 5-year bank loan.

Option 2

You will rent hotel conference rooms for courses. For each course, you will book the room 2-3 days before the course once you are sure that the course will run.

You will employ tutors on a freelance basis, only giving them a firm commitment for each day of teaching at the same time that you book the rooms.

For each course, you will shop around publishing companies for the best deal on course materials.

The necessary IT and projection equipment will be hired on a daily basis, although some hotel rooms have this equipment installed already.

Discuss the advantages and disadvantages with these options.

Answer

Option 1 seems to have created an **organisation**, or company. The organisation owns assets, has employees, and has entered into contracts.

Option 2 seems to involve you running operations from your own home. Everything is organised on a daily basis.

Option 2 would not need much of a financial investment. However, it would cause you a lot of stress because:

- Everything is organised at the last moment possible
- Tutors and teaching rooms may not be available if they are booked so late
- IT equipment may not be available at such short notice
- Getting anything at short notice is likely to involve higher costs

- The time spent sorting all of these things out on a daily basis would be huge.

Option 1 would require a large financial investment – but it would bring you **certainty and control**.

Conclusion

Option 1 would make the directors' lives easier, because of the increased certainty. They would know that rooms, tutors, equipment and materials were always available, making it easier to plan ahead.

After the initial set-up and agreement of contracts, the time saving would be immense, allowing them to focus on strategy.

By having contracts, assets etc., the directors have **internalised transactions.** Since they no longer have to go to external markets, they have increased their **control**. They have also saved the **transaction costs** of searching for the best supplier / tutor / building and negotiating a price, as all of these have been tied up in long term contracts.

The result of all of these benefits?

Directors are likely to prefer to own things, or at least have long-term contracts in place, because it makes their lives easier through increased control and certainty over the future.

As such, they are likely to create larger and larger organisations / companies.

This may be good for them, but may not result in the best decisions for shareholders or other stakeholders:

- the organisation may grow larger than is efficient
- by agreeing long term contracts, the ability to take advantage of good deals in the future may be lost
- because directors will get to know company staff, assets etc. very well (because they are internal), they may simply renew contracts without looking at outside options.

Next time you order a pizza, or buy your lunch, or get your hair cut, ask yourself why you usually go back to the same place, and get the same product as you did last time … it is most likely because you were satisfied last time, so feel **certain** that you will get something that is acceptable this time.

But there may be better options that you have not investigated!

This concept is **bounded rationality**. You are making decisions without all the necessary information about some of the options … so you go for the option you know best.

The main reason that you might change would be if an alternative option presented itself at precisely the right moment – and even then such **opportunism** is not something that everyone would go for! Not everyone is willing to give something unknown a try!

AGENCY THEORY AND TRANSACTION COST THEORY LINK

Transaction Cost theory suggests that companies will keep growing because directors want to make their lives easier, through improved **control and certainty**. This links with Agency Theory in 2 main ways:

- directors seem to be making decisions that are good for them, rather than for shareholders and other stakeholders … the classic agency problem
- by making companies larger and larger, the gap between directors and shareholders is likely to widen, making it more likely that directors will not know what shareholders want (and making it harder for individual shareholders to have a "voice" due to their small % shareholdings).

Chapter 4

Governance in different countries and organisations

EXAM STYLE QUESTIONS

- Explain the differences between legal systems of corporate governance and codes of best practice.
- Explain how and why governance differs between different countries and cultures.
- Explain the extent to which governance principles may apply to organisations other than large listed companies.

CHAPTER CONTENTS

UK CODE OF BEST PRACTICE --- 37

HISTORY OF THE UK CORPORATE GOVERNANCE CODE 37

COMPLY OR EXPLAIN 38

SARBANES-OXLEY ACT (SARBOX, SOX) ------------------------------- 39

GOVERNANCE IN OTHER COUNTRIES --------------------------------- 40

UNITARY AND TWO-TIER BOARDS 40

GOVERNANCE OUTSIDE LISTED COMPANIES------------------------- 42

CHARITIES 42

PUBLIC SECTOR – E.G. COUNCILS 42

FAMILY DOMINATED COMPANIES ------------------------------------ 47

UK CODE OF BEST PRACTICE

Corporate Governance in the UK is covered by the UK Corporate Governance Code, a document that developed over a number of years. The Code is kept up to date by the UK **Financial Reporting Council (FRC)**, and a detailed summary of the Code's provisions was seen in **Chapters 1 and 2** of these Notes.

History of the UK Corporate Governance Code

This is not a history exam! However, the Code includes the results of a number of individual Reports, and it would be reasonable for the P1 Examiner to expect you to recognise the names.

Following a series of high profile corporate collapses in the late 1980s and early 1990s, some of which were detailed in **Chapter 1**, Sir Adrian Cadbury was asked to look into UK corporate governance. In 1992, the **Cadbury Code** was created.

In 1995, following a series of concerns about excessive director pay, the **Greenbury Report** was issued, giving recommendations on how to better align director rewards with those of shareholders.

In 1998, soon after the Cadbury Code had been in use for 5 years, the **Hampel Report** reviewed how well the Cadbury Code was working, and made recommendations for change.

Important issues

There was a concern that the Cadbury Code was too close to a **box-ticking** approach, and was not making companies think enough about the principles involved. As such, Hampel advocated a more **principles-based** code.

The London Stock Exchange operates a **Comply or Explain** approach. All listed companies are expected to follow all provisions of the Code … or explain in their Annual Reports which provisions they have not followed, and why.

In 1999, the **Turnbull Report** was issued. **Turnbull** gives detail on how to create an effective Internal Control System, which is an essential part of good risk management. There is more detail on this in **Chapter 6** of the Notes.

In late 2001, **Enron** collapsed. Whilst Enron was primarily a US company, its operations were international … and it was felt that UK corporate governance may be able to learn some lessons as well.

In 2002/2003, two reports were issued as a result of post-Enron analysis, and both of these reports formed part of the Combined Code in the UK. The **Higgs Report** looked into improving the effectiveness of directors, especially **NEDs**. The **Smith Report** focussed on the role of **Audit Committees**.

The Combined Code was updated again in 2006, but a far more important update was in 2010, when the name was changed to the UK Corporate Governance Code. A review had been due anyway, but the Banking Crisis of 2007-2010 had resulted in numerous issues and concerns, and many of these were relevant to all companies, not just banks.

Comply or explain

The "Comply or Explain" approach is **NOT** the same as saying the Code is Voluntary.

The expectation is that listed companies will follow the UK Corporate Governance Code in full, and that non-compliance (and hence explanations) will be rare.

Having "Comply or Explain", rather than having corporate governance law (as in the US), would seem to have some advantages and disadvantages:

Advantages

- The ability of companies **not** to comply with the standard provisions recognises that not all company situations are the same, and that some flexibility is therefore welcome.
- Laws can appear to be heavy-handed, and often do not therefore get the support of the business community. It is hoped that by avoiding laws, businesses will be more willing to contribute to the ongoing corporate governance debate.
- By requiring explanations of non-compliance, companies are required to think carefully about their reasons … and this may make them decide to follow the Code after all!

Disadvantages

- Some companies may use the ability not to comply in order to avoid some provisions of the Code, and then present weak (or untrue) explanations justifying their actions.
- Without the law to back it up, corporate governance becomes harder to enforce.

SARBANES-OXLEY ACT (SARBOX, SOX)

After the collapse of Enron, WorldCom, and a series of other American corporate frauds and failures, the US Government was keen to act quickly and firmly.

On 30 July 2002, the Sarbanes-Oxley Act was passed (it is named after the 2 US politicians who sponsored it through Congress). It was not long before it became known as Sarbox … or SOX.

There are many differences between SOX and the UK Code:

- SOX is law, with strict penalties for non-compliance. The UK Code is Best Practice, not law.
- SOX makes audit partner rotation the law, whereas in the UK such matters are covered by the profession's Codes of Ethics.
- SOX has a ban on auditors providing a range of "other services" to their audit clients. In the UK, very few "other services" are banned, but are instead considered within the objectivity area of Ethics.
- SOX requires the CEO and CFO to personally attest to the accuracy of the Annual Report, Quarterly Reports, and to the effectiveness of Internal Control Systems. In the UK, there are general assurances in the Directors' Report and Annual Report, but no personal certification is required.
- Under SOX, the auditors must attest the Internal Controls statement. Auditors do not make any such statement in the UK.
- Under SOX, if laws have been broken (e.g. accounting standards), the CEO and CFO forfeit some of their remuneration (e.g. their bonuses). There are no such rules in the UK.
- Under SOX, no loans can be made by a public company to its directors or other senior executives. Whilst the same rules apply in UK law, there is a de minimus limit and there are some exemptions.

In many ways, SOX and the UK Corporate Governance Code are very similar, but in many other ways SOX is much more strict, and of course is backed up by the US law.

The main areas in which SOX is tough are directors, auditors, and internal controls – which is hardly surprising giving many blame Enron's collapse on a failure in those 3 areas.

GOVERNANCE IN OTHER COUNTRIES

Corporate Governance varies around the World, largely due to different history and cultures.

In the UK and US, the model is aimed primarily at the rights of shareholders.

In Germany and much of continental Europe, and also in Japan, **banks** play a more prominent role, often holding shares and having Board members. Such governance models tend to be more inclusive, ensuring that the rights of workers, customers and suppliers (and maybe the community) are represented at Board level.

In Japan, many major company structures were traditionally based around banks. Large groups of companies from many industries would all be financed, and part-owned by a major bank, which would create a strong financial alliance. Cross-shareholdings between companies were common, and in many cases the companies in the "group" would all supply each other.

In South America, Italy, Spain, and large parts of East Asia (e.g. Indonesia) the focus is more on **family ownership**, with a large % of the biggest companies owned and controlled by a small number of the most powerful families in the country.

Unitary and two-tier boards

In countries where there is greater inclusivity in decision-making, or where there is a strong family dominance, it is possible that a **2-tier board** will exist.

A **Management Board** will run the day to day operations of the company, but will be monitored by a higher level **Supervisory Board**. In UK terms, this is similar to having the NEDs on a top board, with the Executive Directors on a separate lower Board.

The 2-tier system may also operate with family dominated companies, with family members having their own top-level private Board which has controlling voting rights (and therefore where the true decision-making power rests).

To an extent, schools in the UK may be seen to have a 2-tier system, with the Head / Principal and a small number of senior teachers on a management board, with the School Governors in a more supervisory role.

Of course, schools naturally have a lot of stakeholders (parents, teachers etc.) so would seem well-suited to this structure.

Advantages of 2-tier boards

- Where there is a large Board, splitting into 2 may make discussion and decision making easier.
- The existence of 2 Boards allows for more stakeholders to be involved.
- By separating NEDs from the Executive Directors, the independence of the NEDs is likely to be improved.

Disadvantages of 2-tier boards

- If one board is clearly senior to the other, it may lead to conflict.
- It may be better for NEDs to be present during Executive Director discussions, rather than receiving a report of what was said.
- It is likely to lead to slower decisions.
- Senior management are now 2 steps away from a final decision, which may demotivate them.
- In many countries (e.g. UK) all directors have equal legal status, whether Executive or NED. This may make it necessary for all to sit on a single Board.

GOVERNANCE OUTSIDE LISTED COMPANIES

The rise in the importance of governance has been fuelled by fraud and corporate collapses, primarily among large listed companies.

But can other companies, and other organizations, learn from corporate governance?

Charities

Consider the following issues:

- Could a Charity suffer from fraud?
- Does a Charity need to manage risks?
- Does a Charity need a strategy and effective leadership?

The answer to all of these questions is of course **yes**!

In the UK, charities are regulated and monitored by The Charities Commission, whose principles demand:

- Sound governance
- Effective controls
- A Board that is competent and independent
- A Board that monitors its own performance
- Training for Board members
- All Board members to identify any conflicts of interest
- Good risk management system.

Of course, charities are typically not companies, and may not be used to behaving in a "corporate" manner, because:

- They are often run by volunteers, who may have minimal business experience.
- They are often much smaller than companies, so are less likely to have the need (or resources) for things like Board Committees.
- Often the founder of the charity leaves rules in place to ensure future decisions are still made according to his original intentions.
- It may seem "harsh" to forcibly rotate a volunteer off a charity's Board.
- It may be that as volunteers, there are no Board remuneration issues (other than reclaimed expenses).

Public sector – e.g. councils

Traditionally, councils were seen as full of faceless officials, inefficiently spending the public's money.

Many would not associate a council with words such as accountability or responsibility, assuming that decisions were often made for political reasons, or because you knew someone on the council and were able to persuade them to get you what you wanted.

However, Councils have also taken many aspects of governance to heart. Consider Harrow Borough Council in London, whose website includes sections on:

- Sustainability
- The councilors, and how elections operate
- How council decisions are made
- Budgets and spending plans
- Council strategy
- Council performance.

Clearly many aspects of corporate governance do not have such importance in a council, but equally there are other areas which do.

Haringey Borough Council seem to go even further – the following shaded pages are taken from:
www.haringey.gov.uk/index/council/ourstandards/ethicalgovernance.htm.

Conclusion

Organisations such as charities, government departments, councils and other non-corporate bodies suffer many of the same issues as large listed companies.

The stakeholders are often different – they may be taxpayers rather than shareholders for example – and will have different "claims" as a result.

Also, the "culture" is likely to be different, especially if the aim is to provide a service rather than profit maximization.

But most of the issues that relate to public companies are likely to affect all types of organization.

Ethical Governance

Standards you should expect from us

In Haringey we are committed to the highest standards of ethical conduct from our Councillors and officers. On this page you will find an outline of these standards. These standards can be found in:

- Part Five, Section A - Members' Code of Conduct and
- Part Four, Section K - Officer Employment Procedure Rules

of Haringey Council's Constitution.

On this page you can also find out about our

- Standards for Councillors - general principles and Standards Committee
- Councillors' Register of Interests and hospitalities
- Customer Standards
- How to report a complaint, compliment or suggestion about a council service
- Whistleblowing

Standards for Councillors

The standards for elected Councillors are clearly set out in The Members' Code of Conduct (see the link above). Listed below are the **general principles** of the code:

Principle	Explanation
Selflessness	Members should serve only the public interest and should never improperly confer an advantage or disadvantage on any person
Honesty and Integrity	Members should not place themselves in situations where their honesty and integrity may be questioned. They should not behave improperly and should on all occasions avoid the appearance of such behaviour.
Objectivity	Members should make decisions on merit, including when making appointments, awarding contracts, or recommending individuals for rewards or benefits. Members should be accountable to the public for their actions and the manner in which they carry out their responsibilities. Members should co-operate fully and honestly with any scrutiny appropriate to their particular office.
Accountability	Members should be accountable to the public for their actions and the manner in which they carry out their responsibilities. They should co-operate fully and honestly with any scrutiny appropriate to their particular office.
Openness	Members should be as open as possible about their actions and those of their

	authority. Members should be prepared to give reasons for those actions.
Personal Judgement	Members may take account of the views of others, including their political groups, but should reach their own conclusions on the issues before them and act in accordance with those conclusions.
Respect for Others	Members should promote equality by not discriminating unlawfully against any person, and by treating people with respect, regardless of their race, age, religion, gender, sexual orientation or disability. They should respect the impartiality and integrity of the authority's statutory officers, and its other employees.
Duty to uphold the Law	Members should uphold the law and, on all occasions, act in accordance with the trust that the public is entitled to place in them.
Stewardship	Members should do whatever they are able to do to ensure that their authorities use their resources prudently and in accordance with the law.
Leadership	Members should promote and support these principles by Leadership, and by example, and should act in a way that secures or preserves public confidence.

Standards Committee

Standards for Councillors are overseen by the independently chaired Standards Committee. The aim of the Committee is to promote high standards of ethical conduct among elected Councillors.

The Standards Committee page also outlines the procedure that you should go through if you want to report a complaint about a Haringey Councillor. The page gives details about the Standards Board for England, an independent body set up to ensure that standards of ethical conduct are maintained across authorities and to deal with complaints of misconduct against individual Members.

|Back to top

Councillors’ Register of Interests and hospitalities

Haringey’s Code of Conduct for Members also requires Members to register their financial and other interests in a maintained and publicly available register. This requirement is to ensure that Members do not have a personal vested interest in a decision made by the Council (whether implemented or not) which might prejudice their judgement. You can access an edited online version of the register from the Register of Councillors' Interests webpage. We also maintain a full register which is open to the public at all reasonable hours and is available for inspection, by appointment, at: River Park House, 225 High Road, Wood Green, London N22 8HQ.

|Back to top

Customer Standards

Our officers are committed to delivering high standards of service provision that includes transparent and accessible governance. The rules governing our officers' conduct are outlined in Haringey Council's Constitution.

Haringey also has a separate Customer Charter that outlines the standards that you should expect from all council officers.

Your feedback helps us to improve our services and ensures that we treat everyone fairly. If you are unhappy with something that we have not done, then please let us know.

|Back to top

How to report a complaint, compliment or suggestion

The complaints, compliments and suggestions webpages explain the various ways that you can contact us to report your feedback.

|Back to top

Whistleblowing

We also have a whistleblowing policy in place for council employees, staff of council contractors, agency staff and trainees. Whistleblowing is a procedure whereby employees disclose any wrong doings (such as fraud, malpractice, or any other illegal act), either on the part of management or by fellow employees. Our policy is based on guidance from the Local Government Board (LGMB). The policy aims to ensure that serious concerns are properly raised and addressed, and is a key tool in delivering good practice.

FAMILY DOMINATED COMPANIES

In family companies, it is often the case that:

- family members have special voting rights.
- family members have guaranteed seats on the board.

This can lead to both positive and negative governance issues.

Positive

- with the family name at stake, there is likely to be a greater feeling of "ownership" on the Board, which may reduce the risk of unethical behaviour.
- to continue the family name, a longer term view of management may occur.

Negative

- a less independent board.
- the board may have a dominant person / group of family members.
- with board members often coming from a single family, there may be a lack of variety in ideas, and an unwillingness to change previous decisions.
- family problems may become business problems.
- there may be unsuitable people on the board, who were elected purely because of their membership of the family.

Chapter 5

Risk management

EXAM STYLE QUESTIONS

- Explain the importance of good risk management as part of good corporate governance.
- Explain how the Board, possibly through a Risk Committee, is central to good risk management.
- Explain the concepts of risk appetite, risk capacity, and risk attitude.
- Describe how a typical risk management process works.
- For a given organisation, suggest the risk categories that could be used when assessing risks.
- Describe different ways in which risk can be measured and assessed.
- Describe the different ways in which risk can be addressed.

CHAPTER CONTENTS

THE IMPORTANCE OF RISK MANAGEMENT---------------------------- 51

THE BOARD AND RISK MANAGEMENT 51

RISK MANAGEMENT PROCESS-- 53

IDENTIFYING RISKS 54

RISK MEASUREMENT 58

MANAGING RISK 59

ALARP PRINCIPLE 59

THE IMPORTANCE OF RISK MANAGEMENT

Risk, in a business sense, is **uncertainty**. If uncertainty is not properly managed, then forward planning will be almost impossible, and the risk of business catastrophe will be great. Directors who fail to manage risk are failing in their duty to shareholders to promote the long term success of the company.

It is not just that things might go wrong … they may of course go right! If an organisation chooses to take no risk at all, it is likely that its **return** will not be very high. Risk-taking is essential, and is the nature of entrepreneurial activity.

The amount of risk that an organisation needs to take, or wants to take, will depend on a number of factors that will be looked at later in this chapter.

As with all aspects of good governance, companies should report on their risk management so that shareholders can assess relevant risks, and what the company is doing in response to them. Disclosures in this area help directors to demonstrate their **stewardship** of the company on behalf of its owners.

The board and risk management

The Board is responsible for **strategic** decisions. As such, the directors need to decide on a suitable **risk strategy**.

This strategy must fit in with overall corporate strategy, or corporate goals are unlikely to be achieved.

Risk strategy

Example

You are the Chairman of the Board of Liverchester Utd football team, currently placed 4th in the League with only a few games left to play. You have called a board meeting to decide on what the club's objective should be for the end of the season – try not to finish any lower than 4th place, or try to push towards the top of the league.

What factors will affect the decision that is taken and once the decision is made, how should the Board ensure that the club is all working together to achieve the chosen objective?

Factors

The Board's choice of objective will be affected by a number of factors:

- **Risk Attitude of the Directors** – are the directors risk-takers, or relatively risk averse? Risk attitude is likely to be affected partly by the industry type (e.g. charities are probably risk averse, whereas venture capitalists are risk takers) and also by the position the company is in – sometimes there is little choice but to take risks to survive.
- **Risk Attitude of other Stakeholders** – the Board will need to consider the views of the owners of the club, and of the supporters … and of any other key stakeholders.
- **Risk Capacity** – if the Board chose to push for the championship, they would need to try to win matches, which may be difficult if the current team lacks a good goalscorer, and if there is no money to buy better players.

- **Risk Appetite** – the combination of attitude and capacity will create the appetite. This appetite can be anywhere on the "continuum" – between "risk averse" at one end and "risk taker" at the opposite end.

Working Together on Risk

Once the objective is selected, the Board need a risk strategy that the whole football club understands and is working towards – they need to **embed** the risk strategy throughout the culture and operations of the club. Let us assume that the Board have decided to push for the glory of winning the league:

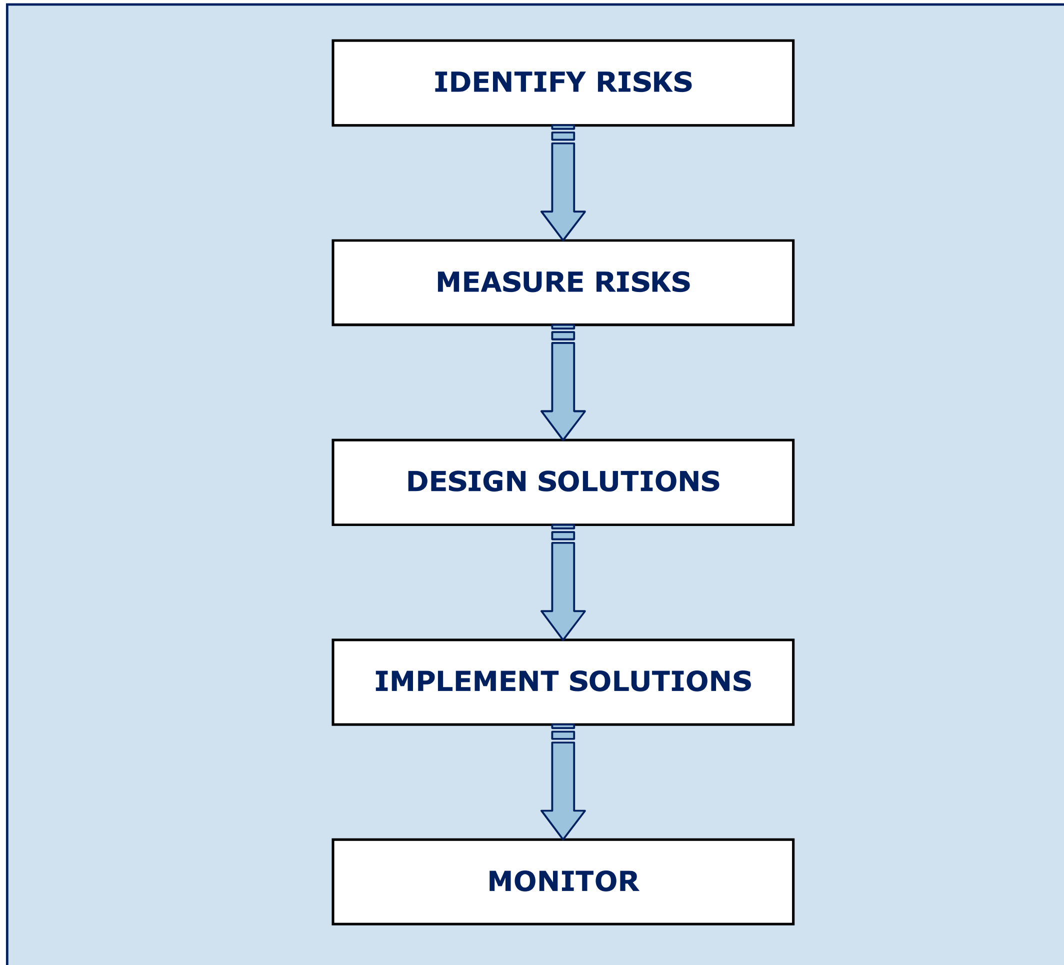
- The Manager, when selecting the team and tactics, needs to focus on winning matches – a draw is not enough! He may need to put several strikers on the substitute bench, so he can bring on fresh goalscoring talent at the end of each match.
- The Players need to understand that winning each game is essential. If they are ahead, they should keep the ball and try to waste as much time as possible. If they are tied with a few minutes left of a game, they need to hurry things up and throw every player forward.
- The coaching staff need to protect key players for the actual games, and not risk injury on the training ground.
- The club doctors need to understand some players may have to play through injuries, and save proper treatment to the end of the season.
- The Board themselves need to ensure they can provide the necessary finance to allow the manager to do what is required.
- Those looking for new players to buy (the "scouts") need to understand that the focus is on players who can score goals, players with a winning mentality etc.

Risk committee

Risk Management is typically part of the **Audit Committee's** job. However, the Audit Committee already has a long list of responsibilities, and in some larger companies there is likely to be a separate **Risk Committee** to deal with the job of monitoring risk management processes (especially the non-financial risks), and ensuring risk strategy is successfully embedded throughout the company.

RISK MANAGEMENT PROCESS

Once the Board has considered its risk strategy, a typical risk management process may look like this:



The process is a continuous **cycle** – in many companies, risks will change on a regular basis (**dynamic**), so a company cannot afford to design solutions and then relax! In other companies, risk may be relatively **static**.

Risks will change over time based on the **turbulence/volatility** in the industry and general economic environment, and can be affected both by external (e.g. recession) and internal (e.g. major rebranding) activities.

Identifying risks

There are many different types of risk, and many methods for identifying them. It is worth noting that many risks are **inter-related**, and may tend to exist together (**positively correlated)** or never exist together **(negatively correlated).**

If a company reduces product quality testing, it will save money and maybe reduce liquidity risk – but on the other hand increase the risk of product returns and reputation damage (a negative correlation – as one risk goes, another arrives). But then reputation damage risk can lead to new financial risks, and poor quality products may lead to legal and regulatory risks (a positive correlation, as the risks create each other).

Methods for identifying risks

- The use of SWOT or PEST / PESTLE analysis
- Brainstorming sessions
- The use of risk questionnaires throughout the organization
- The use of external consultants

Different levels of risk

Risk can occur at different levels:

STRATEGIC RISK

The risk that strategies fail. Major business decisions, such as a re-branding, an acquisition of another company, a merger, could all go wrong.

OPERATIONAL RISKS

The more day-to-day risks for a business, of which there are many types. Whilst operational risks could be viewed as less important than strategic risks, an operational problem can still lead to major business problems.

Directors and senior management need to ensure they do not ignore operational issues because they are focusing on higher level strategy.

Examples of risk types

Business Risk

The risk that a company ceases to be a going concern. This risk can of course vary over time, and depends on the situation a company is in. The risk is that earnings will be poor for a period of time, and the impact depends on the company’s ability to survive this.

Business risks affect the future existence of the company, so ALL stakeholders would be affected to some extent (although some, such as customers, may be able to find a new supplier relatively easily).

Financial Risk

The risk to a company's financial position. Financial risk can increase with **high gearing** levels, because the fixed interest payments are unavoidable (as several European governments have recently discovered).

As long as the financial risk does not affect going concern, the main affected stakeholders are suppliers and lenders (who may not get paid).

This risk has a number of elements:

Credit Risk

The risk that customers fail to pay their bills on time (or at all!)

Market Risk

The risk of changes in the value of a company's financial assets (e.g. shares, bonds)

Liquidity Risk

The risk of running out of cash because inflows are not arriving in time to pay outflows!

Currency Risk

The risk of changing foreign exchange rates in the future. This could lead to:

- **Transaction Risk** – change in the value of a future receivable or payable.
- **Translation Risk** – change in the value of the company's Balance Sheet if year-end exchange rates have changed.
- **Economic Risk** – change in the competitiveness of the company due to longer term changes in exchange rates.

Interest Rate Risk

The change in the value of investments and loans as a result of changing interest rates.

Legal and Compliance Risk

This is the risk of breaching laws and regulations and being fined (or even closed down) as a result. The cost is not necessarily just financial – the time taken in dealing with an investigation can be distracting to the Board.

It also creates **reputation risk**.

Political risk

The risk of operating in a particular country may be high. A change in government or sudden imposition of new laws could make it difficult for the company to operate.

Technology risk

The risk of technological failure, which could be caused by weather, water damage, poor ventilation (leading to overheating) … or simply a badly designed system that fails, or is corrupted.

With the ever growing use of IT, a lack of computer controls could lead to a virus, or staff with a grudge deliberately placing false transactions on the system.

Email or internet access could lead to data corruption.

Health and safety risk

Apart from the risk of injury to employees (who may refuse to work unless the risk is dealt with), poor health and safety can affect the reputation of a company.

Environmental risk

The risk of environmental factors affecting the operations of a business. For example:

- Repeated bad weather leading to farmers having a poor harvest.
- Heavy rain and floods have resulted in Worcestershire County Cricket Club having to close their ground … and look at finding a new home.
- If global warming continues, the tourism industry is likely to see big changes, with traditional beach resorts becoming too hot and tourists seeking new locations where previously temperatures were not tempting enough.

It is also the risk of a business affecting the environment itself. Whether companies should have to worry about such things is considered in more detail in **Chapter 7**.

Fraud risk

The risk of fraud by employees, customers, suppliers etc. There are many different types of fraud, and many reasons why someone may carry it out.

Intellectual property risk

This is the risk of loss of "knowledge". It could be caused by systems failure, but equally could be caused by staff leaving the company and taking knowledge with them.

The risk becomes greater if they have gone to a competitor, where the knowledge they have could be of great value.

It is very difficult to stop someone telling a new employer everything they know – even if legal steps are taken, it is impossible to prove that a private conversation took place.

Reputation risk

Reputation Risk is an extremely important issue for the majority of companies. A bad reputation can wreck a business (Ratners, Andersens) … although sometimes a bad reputation can actually improve profits (Kate Moss, any song banned by the radio stations).

Reputation Risk is affected by every other type of risk, so is very difficult to manage. A good reputation can take years to create, and seconds to destroy!

Industry specific risks

Of course, different risks affect different businesses in different ways.

Some risk types are likely to be relevant to virtually every business:

- Reputation risk
- Fraud risk
- Credit risk

In terms of risk management, a Risk Committee should identify the most important risk classifications for the organization, in order to create a framework for considering risk management. It would be very difficult to sit in a room and think up types of risk with a blank sheet of paper, and not very time efficient to do this at the start of every meeting.

It also helps to assure shareholders if the Annual Report gives an indication of the main risk areas that the company has considered.

EXAMPLE – BARCLAYS

In its 2006 Annual Report (310 pages!!!), Barclays identified the following list of risks that it used as its framework of risk management:

- Credit
- Market (foreign exchange, interest rates, commodity prices)
- Capital (lack of finance)
- Liquidity
- Operational
  - Financial reporting and tax
  - Brand management
  - Corporate responsibility
  - People
  - Regulation
  - Financial crime
  - Strategy
  - Technology
  - Legal and compliance
  - Operations.

EXAMPLE – BRITISH AEROSPACE

In its 2006 Annual Report (a tiny 134 pages), British Aerospace listed the following major risks:

- Reduced defence spending by governments
- Reliance on a small number of large contracts
- Political risk associated with some regions
- Fixed price contracts

- Government regulation (e.g. export controls)
- Inability to control joint venture partners
- Strategic failure of their policy to grow by acquisitions
- Competitors
- Pension scheme deficit
- Foreign exchange
- Legal and compliance.

Risk measurement

Once risks have been identified, decisions have to be taken about how (if at all) they should be managed. Clearly, some risks are more important than others.

Some risk measurement is **objective** – for example, many financial risks can be calculated relatively accurately because a lot of data exists. There is a danger that historical data is assumed to be correct forever, when in fact everything is subject to change over time.

Other risk measurement is more **subjective** – such as the risk of a new competitor entering the market. There is a risk of bias creeping in to such risk assessments, or other forms of inaccuracy. There is also a risk that companies spend more effort managing objective risk areas (because they have mathematical models to do so, such as hedging), and ignore the more subjective areas as they are harder to assess.

Risk prioritisation

There are 2 main variables in assessing the importance of risks:

- Likelihood
- Impact.

Both of these are of course estimates, although some statistical analysis may be possible to improve certainty.

Clearly, high-likelihood, high-impact risks need to be considered first … and low-likelihood, low-impact risks may be completely ignored.

Whilst it appears to be a basic technique, it could be useful for prioritizing an answer to a risk management question in the exam.

Risks can be recorded on a 2x2 matrix – a **risk map** – and the volatility/turbulence mentioned earlier in this chapter will lead to risks moving on the risk map over time – and therefore requiring a different risk response.

Assessing risk

There are many techniques available for quantifying risk:

- **Expected Values** – create an average.
- **Value at Risk** – can help to understand the amount of risk **not** being managed.
- **Worst case / best case** – looks at extremes rather than averages.

Managing risk

There are many techniques available to manage risk. Some look to manage overall risk, whilst others target specific risks. The more turbulence there is (i.e. the more **dynamic** the risk assessment), the wider the range of risk management responses that will be required to be available.

ALARP principle

Risk-taking is an essential part of an entrepreneurial business, but risks should be **as low as reasonably practicable – ALARP**. At a hospital, there is always a risk of contamination – but the only way to eliminate the risk entirely is to shut the hospital, and this is not practicable.

Avoiding risk

Some risks can be totally avoided. If a business has identified that opening a subsidiary in Austria appears high risk, then not opening the subsidiary solves the problem!

However, to totally avoid a business opportunity is often a rather extreme reaction – and if no risks are taken, the chance of **returns** being earned is small!

Reducing risk

Overall Risk Reduction

Risk is the uncertainty caused by variable returns. One way to deal with uncertainty is to **diversify**.

By operating in many different sectors, it is likely that when one sector is performing badly, another will be doing well, leading to a **smoothing** of profits.

Advantages of Diversification

- Smoothing of profits, making forward planning easier
- May be economies of scale between some sectors, however diverse those sectors are.

Disadvantages of Diversification

- Spreading resources and knowledge too thin
- Being reasonable at many things, but not particularly good at any of them, can smooth returns, but at a relatively low average return
- Investors may question the strategy
- Harder to control the business as it grows in size
- Maybe diversification should be left to shareholders …
- Diversification works best where the business areas are **negatively correlated** – and this means they are usually very different sectors where the ability to get economies of scale, share knowledge etc. may be limited.

Risk Pooling

In some areas of a business, risks can be reduced by centrally managing transactions and looking for possibilities to offset positions.

A centralized **Treasury** function can manage cash inflows and outflows throughout a business, matching cash surpluses in one sector with cash deficits in other parts of the business.

Internal Controls

The most common way to reduce individual risks is to design internal controls, a subject that should be well understood from studying the audit paper F8 (2.6).

There are many different types of control mechanism, and these are described in more detail in the next chapter.

Transfer of Risk

The most common way to transfer risk is **insurance** – by paying a premium, the cost of major disasters can be passed on to the insurance company. Insurance companies themselves may seek to transfer away some of their newly acquired risk to other insurance companies, to share the cost of a catastrophe throughout the insurance industry.

There are other ways to transfer risk:

- Joint Ventures or franchise arrangements can help to transfer some of the risk, by sharing with another party.
- It may be possible to pass risk on to employees, suppliers, customers etc., although they are likely to expect payment for this.

Accepting Risk

Some risks will simply be accepted, and nothing done about them. This may be because:

- A deliberate choice has been made to take the risk.
- There is nothing that can be done to manage or avoid the risk.

Note that as well as being able to explain this TARA framework, and use it to suggest risk responses, the examiner may also expect you to use the framework to evaluate the risk responses put in place by a company in a scenario-based question.

Chapter 6

Internal control systems

EXAM STYLE QUESTIONS

- Explain what is required for an effective system of internal controls, as recommended by COSO and Turnbull.
- Explain how the control system at the above company differs from a "sound" system as described in the Turnbull guidance.
- Explain the role of Internal Audit in good corporate governance.
- Explain the role and benefits of an Audit Committee.

CHAPTER CONTENTS

WHAT IS AN INTERNAL CONTROL SYSTEM?---------------------------- 63

LIMITATIONS OF INTERNAL CONTROL SYSTEMS 65

INTERNAL AUDIT --- 66

AUDIT COMMITTEES-- 68

WHAT IS AN INTERNAL CONTROL SYSTEM?

According to the Turnbull guidance in the UK Corporate Governance Code, control systems need to:

- Safeguard company assets
- Maintain the efficient running of the business
- Protect the accuracy of financial reporting information
- Protect the company from breaking laws and regulations
- Reduce the risk of fraud.

There are several ways in which control can be achieved in an organisation:

- The use of contracts (e.g. with employees) to clarify roles and responsibilities
- A system of reward and discipline
- Feedback and feedforward
- A clear organisational and command structure.

It is generally accepted that a good Internal Control System is made up of 5 elements:

- A strong **Control Environment**
- Good **Control Procedures**
- Good **Risk Assessment**
- Good **Information Systems**
- Effective **Monitoring** (typically the role of **internal auditors**).

Control environment

The control procedures are unlikely to be effective unless there is a strong control environment:

- Management Attitude needs to be strong:
  - managers follow same controls as staff, no override
  - those breaching controls are punished
  - controls are part of staff training
- Staff who are likely to follow the controls:
  - recruitment process to get "right" sort of people (e.g. No criminal record)
  - training to ensure all understand importance of controls
- Segregation of Duties
  - different parts of processes done by different people
  - nobody checks their own work
  - nobody has total control of all parts of a transaction

Control procedures

There are several types of control procedure:

C omparison

A uthorisation

R econciliations

C omputer Controls

A rithmetical

P hysical

or **CARCAP** for short.

Example

Your company, Southgate Snax, has recently won a contract to provide on-board refreshments on all the trains servicing the Southern England railway network.

Your company will operate a trolley system serving hot and cold drinks (including alcohol) and a selection of light snacks.

Overall, 128 different routes will be serviced.

Identify the risks involved in this business and suggest some control procedures to manage these risks.

Risk assessment

Clearly, if the risks are not identified properly at the start of a risk management process, the wrong control procedures will be put in place ... and so the control system will fail.

Unfortunately, this issue can never be completely avoided ... because whatever controls you have in place, a clever criminal will inevitably find a way around them!

Information systems

You can only know if your controls are effective if you have accurate information being produced. Inaccurate information may be hiding problems.

Information should be timely, and of a type and format which is useful to those receiving it. Directors would expect higher level summarised information, whereas operational staff would need more detail (and probably more regular information).

Monitoring

On paper, many systems sound fantastic and impossible to break. In reality, the truth is often very different. Despite massive security, high profile buildings often get broken into ... often because the controls that management THINK are happening are in fact routinely ignored.

Companies should monitor their controls to ensure they are taking place, and are achieving the desired effect.

Monitoring is typically carried out by Internal Auditors (see later in this Chapter).

Limitations of internal control systems

Even if Control Systems are assessed as very strong, auditors will still do SOME substantive testing. Controls are never completely reliable because:

- staff make mistakes
- staff collude to override systems
- staff believe the cost of the control is greater than the benefit ... so refuse to do it
- controls are designed for normal events ... unique / new types of transaction may bypass the system.

INTERNAL AUDIT

In running large organisations, directors cannot directly control every event and transaction. They rely on organisational structures, control systems, and risk management processes to ensure the business runs smoothly, fraud is eradicated (as far as possible) etc.

Directors need **assurance** that these processes are working properly, and advice on how improvements can be made. Historically, this is the role of **internal auditors**.

Role of internal audit

Internal auditors will be involved in a wide range of "checking" and reporting activities, including:

- checking that internal control systems are operating
- reporting on the effectiveness of risk management systems
- fraud investigations
- efficiency audits (e.g. Value for Money Audits) on individual departments
- project audits.

Independence of internal audit

Internal auditors are often:

- employees of the organisation
- reporting to the directors …
- …about matters that are the responsibility of the directors!

As such, their independence is bound to be questionable. For example:

- they may ignore frauds because they trust workplace colleagues, or feel sympathy for them
- they may decide not report problems for fear of upsetting their ultimate bosses, the directors
- they may decide not to report problems for fear that the company may get into trouble and they might lose their jobs
- as internal staff, they may be pressured or intimidated into keeping quiet
- if they report to directors and directly criticise them, the report may be ignored.

Improving Independence

- The internal audit function could be **outsourced** to experts (e.g. a firm of accountants!)
- The internal audit function should **not** report to the Board directly … but should first report to an **Audit Committee**, made up of independent NEDs (more detail on audit committees is below).

- The Chief Internal Auditor should have access to the Chairman, or another very senior non-executive director
- Where the internal audit team are internal employees:
  - They should have no operational duties, nor should they have had in the recent past
  - Ideally, they should have no major family or personal ties to operational staff or departments on whom they report
- Where they are outsourced, independence can be improved by following similar guidelines as with external auditors:
  - The same outsource firm should not act as internal auditor for Company X for too many years in a row
  - The outsource firm should not be performing too many other services for the company (as a self-review or self-interest threat may arise)
  - Fee levels should be monitored to ensure that the outsource firm is not too dependent on a single internal audit client.

AUDIT COMMITTEES

Role in corporate governance

- To oversee all financial reporting so as to be assured that the annual report and financial statements present a fair and balanced, accurate view of the company
- To oversee risk management and internal control systems (if there is a separate Risk Committee then the Audit Committee will focus on **financial** controls), and consider the need for **whistleblowing** policies
- To ensure that internal control systems are reviewed for effectiveness at least annually, and that the results of this review are disclosed in the Annual Report
- To liaise with the internal and external audit functions, meet regularly with them, receive their reports, consider the need to replace them etc.

Benefits of audit committees

- Strengthens the independence of internal and external audit functions by:
  - Taking appointment, fee-setting etc out of the hands of executive directors
  - Ensuring that the company, as well as the audit firm, is considering independence
- Raises the profile and importance of audit, risk management etc.
- May help to allow interaction and co-operation between internal and external audit functions
- Provides a quality control function over internal and external audit functions.

Chapter 7

Stakeholder theory and CSR

EXAM STYLE QUESTIONS

- Using theories as appropriate, discuss the extent to which organisations might have a social and environmental responsibility
- For the above company, identify the different groups of stakeholders and discuss the extent to which the company may choose to deal with them
- Discuss the extent to which stakeholders could be held responsible for the behaviour of an organisation

CHAPTER CONTENTS

STAKEHOLDER THEORY -- 71

AGENCY THEORY AND STAKEHOLDER THEORY 71

TYPES OF STAKEHOLDER 71

CORPORATE SOCIAL RESPONSIBILITY? ------------------------------ 74

HOW RESPONSIBLE SHOULD COMPANIES BE? 74

GRAY, OWEN AND ADAMS 74

DIFFERENT AREAS OF RESPONSIBILITY 76

COMPANY ATTITUDE TO CSR 76

WHY DEAL WITH STAKEHOLDERS AT ALL? 77

STAKEHOLDER AND RESPONSIBILITY -------------------------------- 78

STAKEHOLDER ACCOUNTABILITY ------------------------------------- 79

STAKEHOLDER THEORY

Agency theory and stakeholder theory

Shareholders (**principals**) employ directors (**agents**) to run the company for them.

There is a risk that the directors do not run the company in the best interests of the shareholders … and this is the potential **agency problem.**

The question is, is it just about shareholders…

Earlier in the course, we defined corporate governance as "running the company in the best interests of shareholders **and other stakeholders**". This raises a number of questions:

- Who are these other stakeholders?
- To what extent should / could / must the Board take them into consideration as well as the shareholders?
- What if what is good for one stakeholder is bad for another stakeholder?
- What if what is good for shareholders might be viewed as **unethical behaviour**?

Types of stakeholder

Later in the chapter, we will look at the extent to which organisations might want to deal with different stakeholders. But before we do this, we need to consider **who** these stakeholders are, and whether we can group them into different types.

It may be the case that different types of stakeholders behave in different ways towards the organisation, or are affected by the organisation in different ways … and this may result in an organisation treating them in different ways.

What is a stakeholder?

A stakeholder is someone who can affect, or be affected by, the operations of an organization as it seeks to meet its corporate objectives.

Note the **bi-directionality** – it works in both directions, something the examiner has been keen to emphasise.

As such, stakeholders are likely to include:

- Shareholders
- Management
- Employees
- Customers
- Suppliers
- Regulators
- The local community
- The wider community, and planet in general?

Stakeholder claims

Stakeholders may feel they have a claim on an organization – and may make demands in order to try to influence the behaviour of that organization:

- A desire to change the way that an organization affects them (e.g. a local resident may try to stop a local supermarket getting deliveries early in the morning, because of the noise it creates).
- A desire to change the way an organization behaves for ethical reasons (e.g. a protestor tries to stop a company selling certain products because it believes they have been made using child labour).

Direct v indirect stakeholders

Direct Stakeholders make their demands themselves – in other words they have their own voice.

Indirect Stakeholders do not have a loud enough "voice", or may have no voice at all … so their claims are represented by others (or may not be represented at all). Examples may include wildlife, the oceans, the ozone layer, planet Earth, children, future generations yet to be born, very small shareholders, very small customers.

With indirect stakeholders there is a potential form of agency problem, in that those representing their views may not represent them accurately, either on purpose or because they simply cannot be sure (e.g. what are the views of future generations?!!!).

Influence of stakeholders

If we ignore ethical concerns for a moment, and focus purely on practicalities, companies need to understand which groups of stakeholders can influence the company the most – as these stakeholders probably cannot be ignored.

Using a Mendelow Map analysis, those stakeholders with high power and a high level of interest are likely to be active and influential – so they cannot be ignored and need to be actively managed by a company.

Alternatively:

- High Power, Low Interest ... keep them satisfied, and do not upset them!
- Low Power, High Interest ... keep them informed (as they are interested!), and watch their power base. If they are upset, they may seek to increase their power (e.g. by forming alliances with other stakeholders).
- Low Power, Low Interest ... can largely be ignored.

Clearly, the Mendelow approach ignores any moral / ethical considerations of whether stakeholders need to be considered.

Internal v external stakeholders

Internal stakeholders are those within a business (management, staff) whereas external are those outside (government, communities, customers).

Internal stakeholders are likely to have more information, potentially greater interest, and potentially greater influence as a result.

Narrow v wide stakeholders

This distinction is about how different stakeholders are **affected by** an organisation's activities.

Narrow Stakeholders are those most affected by an organisation – and this implies a moral duty of the organisation to consider such stakeholders, and be held accountable to them. This class could include employees, local community, dependent customers and suppliers.

Wide Stakeholders would not be influenced by the organisation so much – e.g. government, wider community, smaller customers.

Primary v secondary stakeholders

This distinction is about how different stakeholders **affect** an organisation.

Primary Stakeholders are those that have a major influence on the ability of an organisation to survive and meet its objectives. A training college without ACCA approval, or without a government licence, would not be a going concern.

Active v passive stakeholders

Active Stakeholders seek to influence an organisation. This group may include regulatory authorities and pressure groups. Whether they are successful in their activities will depend on other factors (e.g. their power, and whether they are seen as **legitimate** – see below).

Voluntary v involuntary stakeholders

Some are stakeholders in an organisation because they choose to be – employees could (normally) work elsewhere, customers can (normally) find other suppliers. Involuntary stakeholders have little choice in the matter.

If there is only one local hospital, all local residents are probably involuntary stakeholders. As such, they are unable to leave a stakeholder relationship and therefore may be compelled to try to influence the organisation, as they have no other option!

Legitimate v illegitimate stakeholders

The ability of stakeholders to have their demands/claims met is likely to be affected by whether a company (and maybe society as a whole) believes their claims to be legitimate.

Claims that are supported by a large section of society are likely to be considered legitimate, as are claims based on current law. Anyone seeking to change society's "norms" or values may have a far harder job having their claims listened to and then accepted.

CORPORATE SOCIAL RESPONSIBILITY

Much of the above analysis helps to split stakeholders into different types, but does not spend long looking at the moral aspect. **Should** companies consider stakeholders at all, and if so, which ones?

As companies have grown into multinational organisations, their ability to affect the world and how society operates has grown as well:

- Companies can change the way society works
  - Mobile phones
  - Email
  - Facebook
- Companies pollute the environment, and big companies can have a noticeable effect on their local community
- A big company in a community will be a major employer – decisions it takes could be the main influence on the prosperity of the community
- Companies who use low cost countries for supplies and services could be seen to be keeping those countries low cost … which could mean they are keeping wages down to what might be viewed as unacceptably low levels

So how much responsibility do these companies have for their actions?

Should we expect companies to consider these responsibilities? Or should we expect governments to set laws for the "good" of society, and simply expect companies to act within those laws?

How responsible should companies be?

There are many different considerations and models, partly because this has been such a major talking point over recent years.

Gray, Owen and Adams

The Gray, Owen and Adams model looks at 7 different levels of how socially responsible we might deem companies to be.

To an extent, they could be seen as a historical development – from the older traditional views at the start, to more progressive modern (and sometimes radical) views towards the bottom:

Pristine capitalist

This is the traditional view, seen by many (but not all!) as outdated today.

Companies are organizations set up to create returns for shareholders. As such, social responsibility is not their concern. Politicians should consider social and environmental issues and set laws if they feel it necessary.

Companies should simply seek to maximize shareholder profits without breaking any laws.

Expedients

Should companies provide Christmas parties for their staff? After all, they generate no profit, and are a pure cost …

Some would argue that companies work their staff hard each year and so the party is part of their reward.

The expedients argument says that the Christmas Party will allow staff to relax, keep them motivated, and be something to look forward to at year end. As such, it will probably be better for long term business prosperity to spend the money and let them have a party – even if deep down the directors would prefer to save the money!

A happy employee is a hard-working employee who is less likely to leave?

Social contract

Companies earn their profits within Society. As such, companies should follow the rules and desires of society, since they are profiting from it.

There is a clear moral dimension to this argument – if you "take", you should expect to "give back" in return.

Social ecologist

Many of the social and environmental problems in the World have been caused by companies, so companies have a moral duty to try to put these problems right.

Also, big companies may be in the best position to deal with these problems – so from a practical standpoint, they should take this as a responsibility to act.

Socialist

Companies should focus first on social and environmental issues, and secondly on profits. Social good must be considered more important than enriching shareholders.

Radical feminist

The business world is incapable of having a social or environmental responsibility, because the business world is a male world of aggression and competition. Even where women are involved in business, they are playing a "male game".

The business world would naturally develop a strong sense of responsibility to society if it was a more feminine world, based on compassion and social care.

Deep ecologist

Social and environmental responsibilities are far too important to entrust to the business world, which will always have the thought of profit at the forefront of its mind.

A completely different model of society is needed where **only** social and environmental issues are considered where making decisions

Different areas of responsibility

Another approach is to look at the areas, or levels at which a company should be thought of as responsible:

Economic

Companies should pay fair salaries, fair prices to suppliers, produce reasonable returns for shareholders (they are stakeholders as well!), charge fair prices to customers.

Whilst many would probably agree with this, the business world typically works on the basis of supply and demand, with prices set accordingly. Fairness is rarely a concern.

However, the growth of **Fairtrade** products, where suppliers are paid a fair price, rather than the cheaper price that the big customer could probably force them to receive, suggests there is belief in this principle.

Legal

Companies should follow the laws and regulations in the countries, and industries, in which they operate.

Again, this sounds sensible. Respect the society in which you are living and operating. But what if you believe that the laws are wrong? Should you accept that different cultures have different ethics? Or is there only one right and wrong – suggesting you have a duty to leave that country or stay and try to change the laws?

Ethical

Companies should always follow what they believe to be the ethical decision. The problem, as we shall see in **Chapter 8**, is whether we can agree what "ethical" actually means, especially in the business world …

Philanthropic

Companies should not simply follow the rules or wait to be told what is expected of them. Companies should look for opportunities to donate money to charity, donate staff time to helping society, provide sponsorship for the Arts, or for community groups etc.

Company attitude to CSR

Reactive

Companies should do nothing and deny all responsibility for corporate social matters.

Defence

Companies should admit responsibility where relevant, then do the absolute minimum to fulfill that responsibility.

Accommodating

Companies should admit responsibility where relevant, then invite those who believe they are responsible to tell them what they should do.

Proactive

Companies should not wait to be told they have a responsibility. They should be constantly investigating where their activities affect society and the environment, and should be going beyond what is expected, and dealing with issues before interested parties criticize them.

Why deal with stakeholders at all?

As we saw earlier in the Chapter, the traditional view is that companies should be run for their owners, the shareholders, and that is all.

However, we also saw that an alternative argument is that it might be good for business ("expedient") to keep staff happy, customers and suppliers happy, the local community happy, etc.

Instrumental

Many believe that companies should demonstrate some CSR purely for profit reasons – that CSR looks good to the outside World and leads to higher sales.

There is no moral element to this decision – the decision is taken purely for profit.

Companies might use CSR to "strategically position" themselves (e.g. rather than being the cheapest, or the highest quality, a company may want to be known as the most socially responsible, or the most "green").

Studies have shown that most consumers in the UK believe that companies are only fighting pollution, being nice to suppliers, and looking after employees because they think it makes them look like good companies and attract customers and profits.

Normative

The normative approach is where companies deal with stakeholders and seek to act ethically and with social responsibility because they think it is the "**right**" thing to do.

Ironically, the need and expectation for companies to disclose CSR related statistics could be the driving force for companies following CSR principles. If they followed CSR but did not tell the outside world, there would be no effect on their image – so instrumentalists would not bother doing it?

Or maybe "ethics" is about doing what you believe to be right, and that which you are happy to be judged on. So by expecting companies to disclose CSR related information, they are forced to think what information they would feel comfortable with, and therefore act to change statistics which make the company look unethical in its own eyes?

STAKEHOLDERS AND RESPONSIBILITY

In much of the above text, we talk about **companies being responsible** – corporate social responsibility.

In law, the concept of corporate manslaughter exists, where a company can be deemed responsible for someone's death.

But whilst a company is a legal entity, like any person is, there are problems in assigning responsibility to the company itself:

- You cannot put British Airways, or Tesco, in prison if they do something wrong
- Any fines or penalties on the company actually affect humans – the shareholders who lose returns, the directors who lose reputation …

So, if Company X is using child labour in some of its overseas factories to keep costs low, and therefore increase its profits, and if this behaviour is deemed socially irresponsible, who should we blame?

The shareholders?

With ownership comes responsibility – that what you own does not hurt others?

This is fine, but if no one shareholder owns a large enough stake to control the company, surely any blame has to be shared amongst all shareholders.

By this argument, companies would need to provide large amounts of detailed disclosure of their activities, because shareholders cannot be held responsible if they have not been told what the company is actually doing …

… or maybe ignorance is no excuse? Maybe shareholders who did not know **should have known**?

The increase in **shareholder activism** in recent years, with Boards of Directors being challenged far more regularly to justify company strategy and actions, suggests that some shareholders believe they have a responsibility … or maybe they are active purely to try to ensure profits are maximized?

There has also been a growth in **Ethical Investment Funds**, allowing investors to direct their cash into companies deemed to have ethical operations.

The directors?

Many would blame the Board, before blaming anyone else, for company activities deemed unethical or irresponsible. After all, it is the Board that creates company strategy and implements it.

However, the Board are there to represent the shareholders (as their **agents**!), so could justify their actions by saying they were simply carrying out the wishes of the shareholders.

Customers?

If nobody purchased the products from a company, the company would not sell those products! So are companies acting unethically because consumers demand it?

The growth in the sale of organic products has partly been slowed by a reluctance from consumers to pay higher prices, especially for fruit and vegetables.

STAKEHOLDER ACCOUNTABILITY

If we believe that stakeholders are important, and if we believe that stakeholders may also have some responsibility for company behaviour, we need to ensure that companies are reporting adequate information to these stakeholders.

Over recent years, company Annual Reports have grown massively in size, and part of this growth has been in **non-financial reporting**.

Triple Bottom Line reporting refers to the growth in Social and Environmental disclosures alongside financial disclosures.

But this raises additional issues:

- Are there any "rules" on what should be reported?
- Will there therefore be any comparability year on year, or within industries?
- Will information reported be balanced ... or will it inevitably be more positive than negative?
- Who (if anyone) will check the accuracy of this information?

There have been developments in these areas in recent years. Environmental accounting and audit frameworks (such as EMAS and ISO14000) have been developed to provide some guidance.

Auditing information is difficult, because unless there are some standards or other criteria to assess against, it is hard to imagine what the eventual audit report might say.

Some companies (such as Shell, BP, British Airways) are actively seeking the views of stakeholders in what they disclose, and are allowing them to report their opinions within the Annual Report.

But maybe there is another solution …

Full Cost Accounting

Assess the costs and benefits to all stakeholders of all company activity, and require these to be shown within a company's performance figures. For example, the cost of pollution clear-up could be put through a company's accounts, thus reducing its profit.

Potentially this could be extended so that the company was forced to actually incur the cost – or be rewarded for any environmental benefits created?

Clearly, this is taking the current accountancy system forward in a very different way!

Chapter 8

Business ethics

EXAM STYLE QUESTIONS

- Should codes of ethics be based on rules or principles?
- Explain the fundamental principles of the ACCA Code of Ethics
- Highlight the issues with conflicts of interest
- Discuss the need for confidentiality when dealing with client affairs
- Describe different frameworks that exist for helping accountants to come to make ethical decisions (including Tucker's 5 Questions, and the American Accounting Association 7 Step Model)
- Explain Kohlberg's stages of moral development and apply them to a scenario
- Explain different models of ethics, including deontological v teleological, relativism v absolutism, personal ethics v corporate ethics
- Explain the concepts of sustainability, environmental footprint, and social footprint

CHAPTER CONTENTS

CODES OF ETHICS -- 83

WHAT *IS* ETHICAL?-- 89

CODES OF ETHICS

Typically, accountancy institutes have a code of ethics, to help guide the behaviour of their members. In recent years, the International Federation of Accountants (IFAC) has created an international code of ethics.

Students need to understand the arguments for and against having such codes (and bear in mind that **companies** may choose to have their own **corporate codes of ethics)**, and be able to describe the fundamental principles typically included.

Do we need a Code of Ethics?

Advantages

- It provides guidance to accountants on what is, and is not, acceptable behaviour
- The principles may help to solve difficult ethical situations (ethical dilemmas)
- The existence of a Code sends a message to the outside world that accountants believe ethical behaviour to be important
- For trainee accountants who do not understand acceptable professional behaviour, the Code represents a useful educational and training aid.

Disadvantages

- If someone wants to be unethical, it is unlikely that the existence of a Code of Ethics will change their behaviour – unless they genuinely did not understand that their behaviour was unethical until they saw the Code
- Producing the Code, and keeping it up to date, is costly
- In different parts of the world, different behaviour may be considered ethical or unethical.

Ethics – principles or rules?

It is usually the case that ethical codes / guidance for accountants are based on principles, with only a limited number of rules. There are several reasons for this:

- It is hard to define rules that would be acceptable to all accountants, and appropriate to all situations.
- Accountants are professionals and should have the ability to make their own behavioural decisions in most cases – they should use professional judgement.
- Where there are rules, there will be some who look for loopholes so that the rules can be avoided or ignored. It is much harder to ignore principles.

Of course, an opposing argument is that it is easy to see when someone breaks a law, but very difficult to prove that someone has breached a principle – as the latter are less defined.

The Fundamental Principles

For many years, a number of fundamental ethical principles have existed in accountancy:

Objectivity

Objectivity is a state of mind where the only matters considered when making a decision, or forming an opinion, are those matters relevant to the situation. Personal issues, conflicts, or the influence of others must be ignored, so that the final opinion given is fair, impartial, and justified.

For example, when deciding how to account for a business transaction, the only matters of relevance should be the facts of the situation and the relevant accounting standards. The effect on company profits is irrelevant to deciding on the correct accounting treatment.

Integrity

Someone with integrity inspires trust because they stick to their principles in all situations. What those principles are will depend on their personal ethical beliefs.

In a professional sense, someone with integrity would be expected to uphold the values of the profession, abide by relevant laws and guidance (but seek to change those laws and guidance where they are not consistent with the principles they believe in), not look the other way when unethical practices are going on, etc.

Due Care and Competence

Professionals should always carry out their work with professional care, and should only accept work that they believe they have the skills and experience to undertake properly.

Professional Behaviour

Accountants should not do anything that could do damage to the reputation of the accountancy profession. "Professional" behaviour is something that is investigated in more detail in **Chapter 9.**

Confidentiality

Accountants will gain knowledge of client information that is private. Such information should not be disclosed to anyone else, unless:

- The law demands it (e.g. suspicion of money laundering, terrorism).
- The client allows it.
- It is in "the public interest".

The problem with the above is trying to define "the public interest", a subject that we will investigate further both in this chapter in the section on **Teleological Ethics**, and in **Chapter 9**.

Ethical Dilemmas

Ethical dilemmas are situations where there may not be one clear course of action that is "ethical", or "morally right". Sometimes such situations can be very difficult to solve.

In some cases, such situations may be avoidable – thus solving the problem! For example, conflicts of interest may be avoidable by taking adequate precautions in advance.

But for some ethical dilemmas, avoidance is impossible. For such situations, there are ethical decision-making frameworks designed to help professionals make a decision in a clear and logical way. Two such frameworks are explained below – the **American Accounting Association 7-step model**, and **Tucker's 5 Questions**.

But first, we will look at conflicts of interest.

Conflicts of interest

As professionals, accountants owe a duty of care to clients – to provide them with all relevant information, and to give the best possible advice.

However, this would be difficult (or maybe impossible) if good advice for client X would be detrimental to the interests of client Y. In such situations, the accountant would be forced to give preferential treatment to one client over another – or resign from both (the more likely solution).

Accountants need to monitor their client relationships to try to spot potential conflicts of interest before they actually arise. This may involve declining to act for some companies, or ensuring that different teams of staff are used to avoid the risk of client knowledge being transferred from one client to the other.

The 7-step AAA Framework for making ethical decisions

In 1990, a report was submitted to the American Accounting Association. It outlined a 7 step process for trying to make ethical decisions. It does not make the decision for you, but tries to ensure that the final decision made takes account of all facts, consequences, and values that are relevant.

The steps are:

- Establish all the **facts** of the situation
- What **ethical issues** are involved
- What are the **principles, social norms, values** that are relevant to the situation. This is likely to include any expectations from your profession
- What **alternative actions** are available (all of them, whether or not they might be ethical)
- Overlay step 3 on step 4 – apply the principles, norms etc. to each course of action
- Consider the **consequences** from each possible action
- **Decide!**

Whilst the steps may appear fairly obvious, they provide a useful and logical thought process. If questioned afterwards as to "why did you choose that course of action?" there will be a clear explanation showing why you did what you did.

Tucker's 5 Questions model for making ethical decisions

Tucker's model is more useful for looking at a particular course of action, rather than deciding between many options.

For any possible action, Tucker requires us to consider 5 questions – although not all of them may be relevant to every situation:

- Would it be **profitable**. This is a difficult question, because it does not address profitable to who, and it does not consider profitability of other options (which may be better)
- Is it **legal**.
- Is it **fair**. Another difficult question. Fair to the person making the decision? Fair to all stakeholders?
- Is it **right**. A third difficult question. What is "right" will differ between people, depending on their ethical views.
- Is it **sustainable / environmentally sound**.

Again, the model seems to ensure that all issues are considered in deciding if a course of action is "ethical" – but it is far from simple to answer all of the questions!

Kohlberg – levels of moral development

The frameworks above give a method for making decisions. However, they do not tell you the correct decision – the decision taken will depend on the individual concerned.

Kohlberg developed 3 levels of moral development – but each level splits into 2, giving a total of 6 levels in total:

Pre-Conventional

Obey or be punished

At the most basic level, people make decisions based on punishment and reward. No particular ethical beliefs have been developed. If action A leads to punishment, then the person ceases to do action A. If action B generates a reward, then action B will be done.

To a certain extent, this level seems to reflect the behaviour of household pets, or small children.

If we believe that people behave in such a way, we can control their behaviour using punishment (via the law) and reward.

Thus, giving tax incentives to companies might improve their environmental record, or encourage them to adopt better corporate governance. Alternatively, legal penalties for excessive pollution, or breaching corporate governance best practice, would seem to be effective.

Instrumental

At a slightly higher level, people learn to do things for the promise of future benefits. Thus, if a colleague arrives late at work and asks you to cover for them, you may choose to do it in the hope / expectation that they will return the favour in the future.

Conventional

Follow your peers

People start to develop behaviour patterns that are based on their family, friends, work colleagues etc. Therefore, if your family members all refuse to wear seatbelts in cars, you may follow and also refuse to wear a seatbelt, because it is the "norm" in your household.

If your work colleagues all overclaim expenses, you do too – it is the accepted way of behaving in your social group.

Follow society

Gradually, this expands into "norms" for society as a whole. If society accepts that parking illegally is ok, as long as you only do it for a few minutes (e.g. as you collect your takeaway meal, or buy a newspaper), then people park illegally and stop seeing it as a problem. It is almost as if there is an exemption in the laws that says you can break the law for a few minutes if you wish, but not for too long!

Post-Conventional

Individual Rights

People eventually start to challenge social norms. It begins at a personal level, refusing to behave as others do because your principles / morals say it is wrong that society has become like this. So you rigidly stick to speed limits because you believe speeding is wrong.

Universal Principles

But at the highest level, this is not enough. Not only will you reject social norms by behaving in the way you believe to be right, you will campaign to change the views of others so that your norms become society's norms.

You may start a protest group, or a religion, aiming to create a new set of moral standards for people's behaviour.

To be so sure of your principles that you are prepared to try to pass them to others, not just stick to them yourself, could be seen as true integrity.

Kohlberg's research has been criticized as over-simplistic, partly because he centred his work on the behaviour of white American males and therefore excluded a large number of others. However, the levels of moral development he highlighted help to explain how over the course of a person's life, they gradually adopt the behaviour and social values of those around them, before questioning those values as they get older.

Other factors affecting decision-making

Moral framing

If ethics are not discussed, it is possible that they will be totally ignored when making decisions.

If the "norm" of the workplace is to behave in a certain way, those who work there may explain this as "this is just the way it is" – nobody questions it, or potentially even thinks to question it.

It may need a new employee (probably at a senior level) to arrive at the company and say something … and once it is said, it is likely that others will be forced to address the ethics of their behaviour.

Unethical behaviour is far less likely if ethics are constantly discussed when making decisions. Ignoring the rights and wrongs of behaviour is easier if the issues are simply not discussed.

Moral intensity

The extent to which ethics / fairness is likely to be in someone's mind when making a decision is also likely to depend on:

- How many people would be affected by your action
- Are these people that you know or care about
- The speed of the consequences
- The impact and likelihood of the consequences
- How society would view your action (and would society find out you had done it!)

WHAT *IS* ETHICAL?

Ethics has different meanings to different people.

To some, there is a fixed set of rights and wrongs that can never change. An action is either ethical or unethical, whatever the circumstances.

Others believe that there is a fixed set of rights and wrongs at any given time – but that over time this can change. Behaviour that was "right" 500 years ago may now be considered unethical.

Similarly, some believe that different ethical rules will need to exist in different countries and cultures, because people are different around the world and there cannot be one set of rights and wrongs that apply to everyone.

Others believe that right and wrong depends entirely on the circumstances, and that there are no rules as such.

In the **exam**, you may be required to use any of the theories in this chapter to comment on someone's behaviour. Whether you believe their behaviour to be right or wrong will be affected by your own beliefs, so be careful! The key is to consider different behaviours and what would cause someone to do them, whether or not you agree with them!

Relativism v Absolutism

Relativism

A relativist believes that different sets of ethical rules are likely to exist, depending on the conditions. Thus, acceptable behaviour in the past has included slavery, child labour, and murder. In many societies today, such behaviour is considered wrong.

Thus, behaviour depends on culture, language, point in history etc.

Absolutism

An absolutist believes there to be one set of unchanging universal truths that always apply.

A similar distinction would be to compare **pragmatic** (relativism) and **dogmatic** (absolutism).

Deontology v Teleology (Consequentialism)

Deontology

Similar to the above, a deontologist believes there are certain principles that are always true, whatever the consequences. Their views are likely to have formed because they believe that a society based on these principles would be "better" than a society that is not.

As such, a deontologist would want these principles to be accepted and followed by all (e.g. by having a legal system based around them).

The word deontology is based on deon, or **duty**. Thus, a deontologist will feel a moral duty (maybe based on membership of a religion) to follow these principles.

Teleology

A teleologist (or consequentialist) believes that ethics is driven by outcomes, not actions. Therefore, if an action achieves a "good" or desirable outcome, the action is ethical.

The question that arises is…

WHAT DO WE MEAN BY A GOOD OUTCOME?

GOOD FOR WHO?

Egoism

An egoist believes that if the outcome is good for you, then the action causing the outcome is ethical. This may at first sound like a very selfish way of making decisions, but it depends on how we evaluate what is good for us.

If I rob a bank and do not get caught, I am wealthy – which would appear to be good for me. On the other hand, I have to live with the secret (which is not so much fun) and the constant risk of being found out. If the bank goes out of business, or people lose their jobs as a result of my theft, this may cause me personal guilt and sadness. Robbing a bank has many consequences for me – it is not just the extra money I will have.

An egoist may choose to follow the rules, donate money to charity, and always do what society expects of them – because it makes them feel good, which is a good outcome.

Utilitarianism

A utilitarian believes that if the outcome is good for **society**, then the action causing the outcome is ethical.

This seems to suggest that anything viewed to be in "**the public interest**" is ethical.

This may suggest that capital punishment – putting a mass murderer to death for his crimes – could be seen as ethical by a utilitarian, because society is saved from further murders, and because other potential mass murderers may stop because they fear the punishment.

However, another utilitarian may feel that if the State kills prisoners, it is effectively saying that murder is acceptable, and this may result in more murders in the future. Also, wrong convictions could never be overturned, which may result in some people being killed for crimes they did not commit.

The most difficult concept here is **the public interest**. If I am making a decision, I need to try to understand:

- Who would be affected by it
- How they would be affected

This in itself is far from easy, but then I need to try to value the positive and negative effects that my actions would have and try to calculate whether my action has a net positive or negative impact on society.

Whilst egoism seems a rather selfish way of behaving, it is far easier to make decisions based purely on the outcome to your own life!

Ethics and CSR

Of course, corporate social responsibility (as seen in **Chapter 7**) can be viewed within the context of ethics – maybe it is ethically correct for businesses to consider other stakeholders such as society and the environment, not just to focus on shareholders.

Some particular ethical issues within CSR include:

Sustainability

Sustainability may be described as meeting the needs of today, without compromising the needs of the future. In other words, something is not sustainable if it cannot carry on in its present form.

Therefore:

- If the fish population replenishes at 1 million fish per hour, but on average 2 million fish per hour are caught, this is not sustainable – eventually there will be no fish
- If oil is extracted from the ground at such a rate that it does not give enough time to find new oil supplies, or an alternative to oil, then this is not sustainable
- If staff are forced to work through the night day after day, they will eventually grow too tired and become sick and unable to work. Such practices will make recruiting new staff very difficult – so the company's activities are unsustainable
- If a company is spending money faster than it is making it, then eventually reserves will run out – it is unsustainable.

Future generations are affected by the business decisions made today, but they have no voice to ensure their concerns are heard. As such, it may be necessary to force businesses (e.g. through law) to consider these stakeholders or they will be ignored.

Environmental Footprint

Your footprint is the imprint you leave after walking somewhere. Likewise, a company's **environmental footprint** is the effect on the environment caused by the operations of a company.

In most cases this footprint is going to be something that society would probably wish to be reduced, as environmental effects are likely to be negative rather than positive. The use of natural resources, creation of waste and pollution are common to many businesses.

However, some businesses may have a positive effect on the environment (e.g. a manufacturer of solar panels).

Some companies have sought to offset their footprint by doing positive things in return. For example, some organizations sponsor the planting of new trees to "offset" the negative environmental effects they create.

Social Footprint

A social footprint is similar to environmental footprint in concept. Businesses leave an impact on society through:

- The social networks created (e.g. work football team, alumni societies for ex-staff)
- The effect of business methods on personal health and human rights
- The additional traffic (both human and vehicles) caused by company operations, and the pressure this puts on roads, bridges and other local services.

With both footprints, the argument is that companies should:

- Understand the footprints they are leaving
- If the footprint is not good for society / environment, seek to reduce it.

Chapter 9

The professional accountant

EXAM STYLE QUESTIONS

- Explain the concepts of a "profession", and "professional behaviour"
- Discuss the responsibilities an accountant has to their employer, and highlight how these may conflict with professional responsibilities
- Describe the influence that a professional accountant can have on society, and whether they should behave reactively or proactively

CHAPTER CONTENTS

PROFESSIONS AND PROFESSIONAL BEHAVIOUR -------------------- 95

WHAT IS A PROFESSION? 95

WHAT IS PROFESSIONAL BEHAVIOUR? 95

A CLASH OF RESPONSIBILITIES? 96

PROFESSIONS AND PROFESSIONAL BEHAVIOUR

What is a profession?

A profession, such as accountancy, is typically associated with the following characteristics:

- Rules, which members are expected to follow
- Standards of work and behaviour
- Quality control monitoring
- A knowledge / skill requirement of its members
- A process to follow in order to join (training, exams etc.).

What is professional behaviour?

In its simplest terms, professional behaviour is behaving in a manner that is prescribed, and expected, by your profession.

In a wider sense, professional behaviour would involve:

- Following the rules and standards mentioned above
- Ensuring your work was always of the best quality
- Not doing anything to damage the reputation of the profession
- Actively trying to improve the reputation of the profession
- Acting in the "public interest" at all times.

The public interest

On many occasions in your studies, you meet the concept of "public interest". For example, auditors are usually expected to keep client information **confidential**; but one exception to this rule is where disclosing the information would be in the public interest.

As noted in **chapter 8**, this is a very difficult concept. For example:

- How many of the public should we consider?
- How many **can** we consider?
- How do we balance up opposing views?

As a result of such difficulties, the professional accountant may find themselves having to exercise judgement (and may benefit from using decision making frameworks, such as AAA and Tucker as seen in **chapter 8**).

Reactive or Proactive?

Should a professional person wait for public interest to make itself known and then react? Or should professionals seek to be proactive?

The answer is probably both, and the accountancy profession has shown examples in recent years:

- When accounting rules and standards are criticized, they are often swiftly changed to try to react to such criticism. For example, FRS 12 / IAS 37 Provisions and Contingencies was issued largely to deal with problems associated with profit manipulation.
- In 2007, the Big 4 Firms issued a joint statement criticizing the current system of accountancy. Rather than so much concentration on quarter end and year end reporting, they suggested that companies should link their accounting systems to their websites, so that accounting information could be available real time, and constantly.

The latter example shows that the accountancy profession does not just wait for criticism – it is also willing to create public debate and set an agenda for future development.

A clash of responsibilities?

As a **professional**, an accountant has responsibilities as described earlier in the chapter.

However, accountants also have responsibilities to others, such as family, religious groups etc. Of particular interest are a professional's responsibilities to **employers**.

As an employee, you have contractual (and ethical) responsibilities:

- To abide by your contract
- To follow the rules of your workplace
- To do as your employer says
- To show a duty / loyalty to your employer and act in the organisation's best interests (e.g. by acting in the best interests of the organisation's shareholders and other stakeholders)
- To carry out work honestly and not allow personal interests or pressures to outweigh employer interests
- To keep employer information confidential.

Clearly, if your employer expects you to behave in one way, but your profession expects you to do something else, then you face a conflict.

Possible solutions to this conflict could be:

- Allowing loyalty to your employer to override professional behaviour
- Following professional standards, and risk upsetting your employer / losing your job
- Resigning from your employment on points of professional principle
- Doing as your employer requests, but insisting that your opposition to the action is recorded, and making it clear that you are acting under the wishes of others, and would prefer not to be doing it.

Whilst on paper these options seem clear enough, and the most preferable solution would seem to be always sticking to professional principles, reality is far more difficult.

An employer can put a great deal of pressure on an employee, such that even someone with high integrity may at least consider breaching professional principles.