# Paper P1

**Governance, Risk and Ethics**

Three-hour examination + 15 min reading time

<table>
<thead>
<tr>
<th>Section A:</th>
<th>Number of marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compulsory scenario based question</td>
<td>50</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Section B:</th>
<th>Number of marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Two out of three 25-marks questions</td>
<td>50</td>
</tr>
</tbody>
</table>

**Total:** 100
Paper P1
Exam

Section A:
- several distinct tasks
- quite broad syllabus coverage
- *might* contain elements of governance, risk, internal control, and *will* include some aspect of ethics
- 'professional marks' – 4-6 marks.

Section B:
- explore one part of the syllabus in a little more depth, while including content from other parts as well
- At least 1 – focused on **Governance**; at least 1 – focused on **Ethics**;
P1 SYLLABUS

A. Governance and responsibility
B. Internal control and review
C. Identifying and assessing risk
D. Controlling and managing risk
E. Professional value and ethics
A. Governance and responsibility

Scope of governance
Agency relationships & theories
The system by which companies are directed and controlled in the interests of shareholders and other stakeholders
Ownership vs Control
Purposes & Objectives of CG

PURPOSES

Monitor those, who control investors’ resources

OBJECTIVES

Improve corporate performance & Accountability

↓

LT shareholder value

PRIMARY

• Balance of power in BOD
• Fair directors remuneration
• Monitor & manage risk – BOD responsibility
• External auditors independence
• Other issues (ethics, CSR, whistleblowing)

SUPPORTING

• Control the controllers
• ↑ confidence & transparency of activities for investors
• Legal & ethical running of the company
• Build in control at the top
Key concepts of CG

- Fairness
- Openness / transparency
- Independence
- Probity / honesty
- Responsibility
- Accountability
- Reputation
- Judgement
- Integrity

Moral stance
CG and different types of companies

- Listed companies
- Private companies
- Not-for-profit organisations
any person or group that can affect or be affected by the policies or activities of an organisation

► operational role
► role in CG
► interests in the company ('claims')
Internal stakeholders

- Directors / BOD
- Company secretary
- Sub-board management
- Employees
- Employee representatives
External stakeholders

- role in influencing the operation of the company
- own interests and claims in the company.

- Auditors
- Regulators
- Government
- Stock exchange
- Small investors
- Institutional investors
Agency theory

Principal: E.G. Shareholders

Employed by:

Agent: E.G. Directors

Accountable to:

On behalf of:

Task: E.G. Managing the company

To perform:
Agency theory and CG

1. Companies owned and managed by same people
2. Expansion required investors (shareholders – limited liability)
3. Delegated running of company to managers (agents)
4. Separation of goals
5. Agency problems
Agency costs

Principals monitoring activities of agents

✔ incentive + remuneration for directors
✔ annual report data (committee activity and risk management analysis, review)
✔ cost of meetings with financial analysts and principal shareholders
✔ accepting higher risks
✔ monitoring behaviour

➡ Residual loss
Agency problem resolution measures

- Meeting – Principal/key investors
- Voting at AGM
- Resolutions at AGM
- Accepting takeovers
- Divestment of shares
Agent accountability

- act in shareholders' interests
- provide good information
- operate within a defined legal structure

Other accountabilities

- Managers to directors
- Employees to managers
- Management to creditors
- Auditors to shareholders
Transaction cost theory

TYPES OF COST

SEARCH AND INFORMATION

BARGAINING AND DECISION

POLICING AND ENFORCEMENT
Transaction costs can be further impacted
Conclusions from transaction cost theory

- Opportunistic behaviour → dire consequences on financing and strategy
- Governance costs build up including internal controls to monitor management
- Managers become more risk averse seeking the safe ground of easily governed markets
## Agency VS Transaction Cost Theory

<table>
<thead>
<tr>
<th>Agency</th>
<th>Transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>individual agent</td>
<td>individual transaction</td>
</tr>
<tr>
<td>directors to act in their own best interests</td>
<td>arrange transactions in an opportunistic way</td>
</tr>
<tr>
<td>shareholders ownership rights protection</td>
<td>effective and efficient accomplishment of transactions</td>
</tr>
</tbody>
</table>
Agency theory is a narrow form of stakeholder theory.
A. Governance and responsibility

Corporate governance approaches
Session Content
In favour of rules-based approach

Organisation’s perspective:
- Clarity of requirements
- Standardisation for all companies
- Binding requirements

Wider stakeholder perspective:
- Standardisation across all companies
- Sanction
- Greater confidence in compliance
Against a rules-based approach

Organisation’s perspective:
- Exploitation of loopholes
- Underlying belief
- Flexibility is lost
- Checklist approach

Wider stakeholder perspective:
- ‘Regulation overload’
- Legal costs
- Limits
- ‘Box-ticking’
SOX KEY POINTS

Auditor independence
Auditors are restricted in the additional services they can provide to an audit client.

Audit committee
Company must have an audit committee – will be disallowed from trading if it does not have one.

Audit partner
Senior partner must be changed every five years.

Restrictions on dealing
Directors prohibited from dealing in shares at ‘sensitive times’.

Increased financial disclosures
Financial reports to detail off balance sheet financing.

Internal control report
Annual report must include statements concerning the internal control systems in the company. (Section 404)

Accuracy of financial statements
Must be vouched for by CEO and CFO
SOX – advantages and disadvantages

**Advantages:**

- Personal liability
- Arm length – Companies and auditors
- Communication to SHH
- Investor & public confidence
- Internal control
- CG – Audit committee

**Disadvantages:**

- Costs
- Flexibility
- Risk taking & competitiveness
- Impact to stop abuse
- Legal min standard
Divergent governance

- non-governmental organizations (NGOs)
- smaller limited companies
- US companies
- private or family companies
- global organisations.
Family structure (vs joint stock)

Benefits:
- Fewer agency costs
- Ethics
- Fewer short-term decisions

Problems:
- Gene pool
- Feuds
- Separation
Insider-dominated structure (vs outsider-dominated)

**Benefits:**
- Fewer agency problems & costs
- Lower cost of capital
- Greater access to capital
- Less short-termism
- Greater input to decisions

**Problems:**
- Lack of minority shareholder protection
- Opaque operations
- Misuse of power
- Market does not decide or govern
International convergence

CG Codes for multiple jurisdictions

OECD principles of CG
- CG framework
- Rights of SHH
- Equitable treatment of SHH
- Role of stakeholders
- Disclosure & transparency
- Responsibilities of board

ICGN statement on CG principles
- Objective – SHH return
- Disclosure & transparency
- Audit
- SHH ownership, remedies, responsibilities, voting rights
- Corporate boards
- Remuneration policies
- Corporate citizenship
- CG implementation
A. Governance and responsibility

Board of Directors
Roles and responsibilities of directors

- entrepreneurial leadership of the company
- represent company view and account to the public
- decide on a formal schedule of matters for board decision
- mission and purpose (strategic aims)
- CEO, chairman and board members
- set values and standards
- company’s management performing its job correctly
- establish appropriate internal controls
- ensure that necessary financial and human resources are in place
- ensure that its obligations to shareholders and other stakeholders are understood and met
- meet regularly to discharge its duties effectively
- assess its own performance and report it annually to shareholders
- submit themselves for re-election at regular intervals.

For listed companies:
- appoint NEDs
- establish committees – remuneration, nominations, audit
Problems for board

- Rely on management to report information to them
- Unfamiliar with each other
- CEO often have forceful personalities
- CEO’s performance judged be the same directors, who appointed him/her
Diversity

Range of visible and non-visible differences that exist between people

Create a productive environment

- Women on the board
- Diversity of Non Executive Directors
Meetings

- agenda – balance between long- and short-term issues
- every director should have the opportunity to place items on the agenda
- all topics should have supportive information (risks and alternatives)
- meetings should be regular and attendance expected.
- chairmen should direct proceedings allowing ample time for discussion and input from everyone prior to decisions being made.
- where necessary board away-days to strategic sites, or supportive strategy briefing meetings should be used.
Board structures

- UNITARY
  - SINGLE BOARD COMPRISING
    - EXECUTIVE DIRECTORS
    - NEDS
- TWO-TIER (DUAL)
  - TWO BOARDS
    - MANAGEMENT BOARD (LOWER TIER)
    - SUPERVISORY BOARD (UPPER TIER)
Two-tier board

Lower tier

✓ day-to-day running
✓ includes executives
✓ CEO co-ordinates activity.

Upper tier

✓ appoints, supervises and advises members of the management board
✓ strategic oversight
✓ includes employee representatives, environmental groups and other stakeholders’ management representatives (these NEDs are not considered to be 'independent NEDs')
✓ chairman co-ordinates the work
✓ members are elected by shareholders at AGM
✓ receives information and reports from the management board.
Two-tier board

**PROs**
- ✓ Clear separation
- ✓ Implicit shareholder involvement
- ✓ Wider stakeholder involvement
- ✓ Independence of thought, discussion & decision
- ✓ Direct power over management

**CONs**
- o Dilution of power
- o Isolation of supervisory board
- o Agency problems between boards
- o Bureaucracy
- o Reliant upon relationship between chairman & CEO
Non-executive directors (NEDs)

- **Strategy Role**: Contribute to development of strategy
- **Risk Role**: Financial systems accurate and risk management robust
- **Scrutinising Role**: Review the performance of management in meeting objectives
- **People Role**: Decide remuneration of board and ensure appropriate succession planning

Roles of NED
NEDs independence

➤ BOD – 50% independent NEDs excluding the chair.

➤ 1 NED – senior independent director who is directly available to shareholders

Reasons:
✓ detached and objective view of board decisions.
✓ expertise and communicate effectively.
✓ independent voice for shareholders on the board.
✓ confidence in corporate governance.
✓ reduce accusations of self-interest in the behaviour of executives.
Threats to independence

- Material business relationship with company in last 3 years
- Employee in last 5 years
- Cross-directorship in other companies
- Receive other remuneration from the company besides director’s fee
- Close family ties with director
- Significant shareholder
- Served on board for more than 9 years

Situations in which NEDs are likely not to be independent
Cross-directorship

Company A

<table>
<thead>
<tr>
<th>Dir X</th>
<th>ED</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dir Y</td>
<td>NED</td>
</tr>
</tbody>
</table>

Company B

<table>
<thead>
<tr>
<th>Dir Y</th>
<th>ED</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dir X</td>
<td>NED</td>
</tr>
</tbody>
</table>

may also involve some element of cross shareholdings

EXPLICITLY FORBIDDEN
NEDs

**Advantages:**
- Monitoring
- Expertise
- Perception
- Communication
- Discipline

**Disadvantages:**
- Unity
- Quality
- Liability
Chairman & CEO

- ensure the board sets and implements direction and strategy effectively
- company’s lead representative

- take responsibility for the performance of the company
- report to the chairman and/or BOD

No individual should have unfettered power of decision
## Chairman & CEO

<table>
<thead>
<tr>
<th>Chairman</th>
<th>CEO</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ leadership to the board</td>
<td>✓ policies to execute strategy</td>
</tr>
<tr>
<td>✓ composition and structure of the board (size, balance, interaction,</td>
<td>✓ full accountability to BOD for operations, controls and</td>
</tr>
<tr>
<td>harmony and effectiveness)</td>
<td>performance</td>
</tr>
<tr>
<td>✓ agenda for meetings</td>
<td>✓ financial and physical resources</td>
</tr>
<tr>
<td>✓ chair meetings</td>
<td>✓ effective management team</td>
</tr>
<tr>
<td>✓ board gets appropriate, accurate, timely and clear information</td>
<td>✓ operational, financial, planning, risk and IC systems in place</td>
</tr>
<tr>
<td>✓ effective contribution from NEDs</td>
<td>✓ monitor operations and financial results</td>
</tr>
<tr>
<td>✓ meet with the NEDs</td>
<td>✓ interface between BOD &amp; employees</td>
</tr>
<tr>
<td>✓ chair the AGM</td>
<td>✓ assist in selection &amp; evaluation of board members</td>
</tr>
<tr>
<td>✓ discuss governance &amp; strategy with the major shareholders</td>
<td>✓ represent the company to major suppliers, customers, professional</td>
</tr>
<tr>
<td>✓ ensure the views of shareholders are communicated to the board</td>
<td>associations, etc.</td>
</tr>
</tbody>
</table>
For and against splitting

**Reasons for:**
- Representation
- Accountability
- Temptation

**Reasons against:**
- Unity
- Ability
- Human nature
Induction and CPD

- Board of Directors
- Induction Requirements
- Understanding of Company
- Link with Employees
- Induction Programme
- Continuing Professional Development (CPD)
- Expand and Update Knowledge
- Formal CPD Programme
Objectives of induction

► communicate vision and culture.
► communicate practical procedural duties.
► reduce the time taken for an individual to become productive in their duties.
► assimilate an individual as a member of the board.
► ensure retention of individuals for future periods.
Induction package

Immediate provision

- Director's duties
- Company strategies
- Board operations

A few months later

- history and brochures
- details of advisors and contacts
- details of major shareholders
- shareholder relations policy
- AGM circulars from 3 previous years
- management accounts

- risk management procedures
- Policies
- Recent press releases etc
- 5 largest customers & suppliers
- code of compliance
Legal and regulatory framework
<table>
<thead>
<tr>
<th>Objective</th>
<th>Protect the owners of the company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Power</td>
<td><strong>Limitations:</strong></td>
</tr>
<tr>
<td></td>
<td>- articles of association</td>
</tr>
<tr>
<td></td>
<td>- shareholder resolution</td>
</tr>
<tr>
<td></td>
<td>- provisions of law</td>
</tr>
<tr>
<td></td>
<td>- board decisions</td>
</tr>
<tr>
<td></td>
<td>unlimited liability – cannot delegate</td>
</tr>
<tr>
<td>Fiduciary duties</td>
<td>- duty to act in good faith</td>
</tr>
<tr>
<td></td>
<td>- duty of skill and care</td>
</tr>
<tr>
<td>Penalties</td>
<td>If the director is in breach:</td>
</tr>
<tr>
<td></td>
<td>- any contract may be void</td>
</tr>
<tr>
<td></td>
<td>- personally liable for damages in compensation for negligence</td>
</tr>
<tr>
<td></td>
<td>- may be forced to restore</td>
</tr>
</tbody>
</table>
Retirement by rotation

► at the first AGM all the directors retire

► at each subsequent AGM, 1/3 of the directors are subject to retirement by rotation

► directors to retire by rotation – those who have been longest in office since their last appointment or reappointment

► directors should be re-elected at least every 3 years.

► all directors in FTSE 350 companies should be put forward for re-election every year (Provision B.7.1).
Director’s service contract

- key dates
- duties
- remuneration details
- termination provisions
- constraints
- other ‘ordinary’ employment terms.
Removal of director

- resignation by notice / without notice
- not offering self for re-election
- death in service
- personal bankruptcy, or other reasons for disqualification
- failure of the company
- disciplinary offences
- statute
- absence for more than six consecutive months
- ‘agreed departure’
Disqualification

- allowing the company to trade while insolvent
- not keeping proper accounting records
- failing to prepare and file accounts
- being guilty of three or more defaults in complying with companies’ legislation regarding the filing of documents with Companies House during the preceding five years
- failing to send tax returns and pay tax
- taking actions that are deemed to be unfit in the management of a company
Conflict of interests

- Directors contracting with their own company
- Contracts with listed companies
- Substantial property transactions
- Loans to directors

CONFLICT OF INTEREST
Insider dealing/trading

illegal purchase or sale of shares by someone, who possesses inside information about a company’s performance and prospects which, if publicly available, might affect the share price.

⚠ Inside information - not available to the market or general public, confidential
⚠ These types of transactions are considered fraudulent
⚠ The ‘director insider’ – to put the shareholders’ interests before their own
⚠ In such cases the insider is violating his contract with, and fiduciary duty to, the shareholders
Directors – performance evaluation

- Performance Evaluation
  - Board as a Whole
  - Directors Individually
  - Board Committees
Performance evaluation. Guidance

- Evaluation should suit Co’s needs & circumstances
- Disclose the fact of evaluation
- Chairman is responsible
- External 3rd party evaluator - objectivity
- A number of suitable questions and answers
- Improves BOD effectiveness, max strengths, tackle weaknesses
- Results of BOD evaluation – shared with BOD
- Individual results – confidential
Performance evaluation. Individual director

- Independence
- Preparedness in self-briefing.
- Participation in meetings.
- Committee membership.
- Positive impact on organisational activity.
Performance evaluation. Board

- performance vs objectives
- contribution to testing & development of strategy
- contribution to risk management
- composition of board and committees appropriate
- relationships inside and outside the board effectiveness
- responses to problems/crises
- matters reserved for the board the right ones?
- communication with management, employees & others
- using AGM and the annual report mechanisms
- up to date with latest developments?
- board’s committees effectiveness
Performance evaluation. Chairman

► demonstrating effective leadership of the board?
► relationships & communications with shareholders well managed?
► relationships & communications within the board constructive?
► agenda setting processes working?
► do they enable board members to raise issues and concerns?
► company secretary used appropriately and to maximum value?
Performance evaluation. Chairman & NEDs

- well prepared and informed for meetings?
- willingness to devote time & effort?
- quality and value of their contributions
- contribution to strategy & risk management
- effectively testing information and assumptions?
- maintaining own views and resisting pressure
- following up their areas of concern?
- effective & successful relationships and communication?
- performance & behaviour ➔ mutual trust & respect?
- refreshing knowledge and skills to be up to date?
- ability to present views convincingly & diplomatically
- listen and take on board the views of others?
Board committees
Importance of committees

► reduces board workload, enables them to improve focus on other issues
► creates structures that can use inherent expertise to improve decisions in key areas.
► communicates to shareholders that directors take these issues seriously.
► increase in shareholder confidence.
► communicates to stakeholders the importance of remuneration and risk.
► satisfy requirements of the UK Corporate Governance Code (2010) (or other governance requirements).
Nomination committee

there should be a formal, rigorous and transparent procedure for the appointments of new directors to the board

► creation of a nominations committee
► majority of NEDs, the chairman should chair
► evaluation of candidate’s skills, knowledge & expertise
► chairman’s other commitments noted in the annual report
► NED terms and conditions available for inspection
► executives not members of any other FTSE 100 company board
► separate section of the annual report should describe the work of the committee.
Responsibilities of nominations committee

► review regularly the structure, size, composition of the board and make recommendations
► balance between EDs and NEDs
► appropriate management of diversity
► appropriate balance of power in executive selection by the CEO/chairman
► evaluate the balance of skills, knowledge and experience
► give full consideration to succession planning for directors
► prepare a description of the role and capabilities required
► identify & nominate for the approval by the board candidates to fill board vacancies
► recommendations to the board re reappointment
► operate independently for the benefit of shareholders
CEO/chairman succession

- nomination committee access to senior managers to gauge performance
- have some idea of a successor in case the new CEO dies or leaves
- monitor senior managers and cultivate possible successors
- search firm to be retained for this and other directorship identification
- think very carefully as to whether the company wants a visionary at the helm or someone who can execute strategy effectively.
A. Governance and responsibility

Board remuneration
### Remuneration committee

<table>
<thead>
<tr>
<th>Role</th>
<th>Reward policy that attracts, retains and motivates directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Objectives</td>
<td>- Independent (with access to own advisors)</td>
</tr>
<tr>
<td></td>
<td>- Clear R policy and shareholders support</td>
</tr>
<tr>
<td></td>
<td>- Performance packages aligned with LT shareholder interests and are challenging</td>
</tr>
<tr>
<td></td>
<td>- Clear and concise reporting</td>
</tr>
<tr>
<td>Responsibilities</td>
<td>- Determine &amp; review framework, policy, spec terms for R</td>
</tr>
<tr>
<td></td>
<td>- Recommend &amp; monitor level and structure of R</td>
</tr>
<tr>
<td></td>
<td>- Set pension provision policy for board members</td>
</tr>
<tr>
<td></td>
<td>- Set detailed R for EDs &amp; CHM (incl pension&amp;compens)</td>
</tr>
<tr>
<td></td>
<td>- EDs and key management are fairly rewarded for contribution</td>
</tr>
<tr>
<td></td>
<td>- Show to SHH that R is set by independent individuals</td>
</tr>
<tr>
<td></td>
<td>- Agree compensation for loss of office of any ED</td>
</tr>
<tr>
<td></td>
<td>- Disclosure of R = Directors’ Remuneration Report Regulations 2002 and the Code</td>
</tr>
</tbody>
</table>
Remuneration policy and strategy

too small  too easily earned

REMUNERATION POLICY

Affects
Attraction
Recruitment
Retention
Motivation

of employees

Covers
• Levels of salary paid
• How this compares with other businesses in same sector
• Mix of salary and other benefits provided.
Components of directors' remuneration package
Basic salary definition

Job itself

Skills of individual

Individual’s performance

Individual’s contribution to company strategy

Market rates

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Quality in Everything We Do
Performance-related elements of remuneration

Performance-related element should form a significant part of the total R package

Short-term bonus
- paid at the end of the year

**Bases:**
- ✓ Operating/pre-tax profits
- ✓ EPS
- ✓ Total SHH return
- ✓ EVA

Share options
- Align interests of SHH & managers
- Eliminating agency problem
  - ✓ Approved by SHH
  - ✓ Replace existing schemes
  - ✓ Should not be excessive

**Payout:**
- ✓ Challenging performance criteria
- ✓ Phased
## Performance-related elements of remuneration

<table>
<thead>
<tr>
<th>Pension contributions:</th>
<th>Benefits in kind:</th>
</tr>
</thead>
<tbody>
<tr>
<td>➢ Only basic salary pensionable</td>
<td>➢ Non-wage compensations</td>
</tr>
<tr>
<td>➢ Consider consequences and associated costs</td>
<td>➢ Expected? Increase loyalty &amp; motivation?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Guaranteed bonus (golden hellos)</th>
<th>Loyalty bonus / retention payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>➢ Uncommon</td>
<td>➢ Rotation preferred</td>
</tr>
<tr>
<td>➢ Used to retain</td>
<td>➢ CG: to link bonus to performance</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Loans</th>
<th>Retirement benefits:</th>
</tr>
</thead>
<tbody>
<tr>
<td>❌ Not prohibited in many countries</td>
<td>➢ Relate to performance achieved</td>
</tr>
<tr>
<td>❌ Poor justification</td>
<td>➢ E.g. lifetime use of plane</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Deferred payments, transaction bonus</th>
<th>Termination:</th>
</tr>
</thead>
<tbody>
<tr>
<td>➢ Stock options for future periods</td>
<td>➢ Awards for services rendered</td>
</tr>
<tr>
<td>➢ Successful conclusion of a deal</td>
<td>➢ Limiting forced termination</td>
</tr>
</tbody>
</table>
Other issues

Legal issues:
- compensation commitments in case of early termination
- avoid rewarding poor performance

Competitive issues:
- too small
- too big

Ethical issues:
- Ethical issues & commercial success
- Directors ⇒ ‘good corporate citizens’
- Reaction to corporate failures
- Public perception of ↑pay in ↓Co’s
- BP disclosure requirements ⇒ policies in line with BP
- Business ethics ☑ management process, pay systems, contracts

Regulatory issues:
- Directors submit clear, transparent, understandable report to members at AGM with R details
- R packages rose due to:
  - additional demand on directors
  - additional responsibilities
  - potential liability
  - heightened external scrutiny
A. Governance and responsibility

Relations with shareholders
Session Content
Institutional investors

PROBLEMS
- Short-termism of fund managers
- Lack of skills of trustees
- Lack of influence of individual SHH

IMPORTANCE
- increasing dominance
- contribute to governance

TYPES
- pension funds
- life assurance companies
- unit trust
- investment trusts

SHH ACTIVISM
- voting rights
- engagement and dialogue
- board composition/governance
- presenting resolutions
- requesting an EGM
Institutional shareholder intervention conditions

- Strategy
- Operational performance
- Acquisitions and disposals
- Remuneration policy
- Internal controls
- Succession planning
- Social responsibility
- Failure to comply with relevant codes
International vs national standards and regulation

**General Meetings**

**Annual General Meeting**
- Must be held once every calendar year.
- Legally required.
- Separate resolutions for each issue.
- Not less than 21 days’ notice required.
- First must be held no more than 18 months after date of incorporation, and thereafter no more than 15 months between meetings.
- All shareholders must be notified and entitled to attend.
- Annual accounts and appointment of auditors (if appropriate) approved at this meeting.

**Extraordinary General Meeting**
- No set timetable – held on an ‘as required’ basis.
- No legal obligation to have any.
- Separate resolutions for each issue.
- Not less than 14 days’ notice required.
- All shareholders must be notified and entitled to attend.
- Agenda dictated by need for meeting.

*Ernst & Young*
*Quality In Everything We Do*
Proxy voting

- each resolution - vote for or against **or** to withhold their vote
- ‘vote withheld’ - not a vote in law
- all valid proxy appointments received for general meetings are properly recorded and counted
- following information should be given at the meeting and made available on a website:
  - number of shares in respect of which proxy appointments have been validly made
  - number of votes for
  - number of votes against
  - number of shares - vote was directed to be withheld.
Disclosure – general principles

MORE REGULAR AND CONSTRUCTIVE DIALOGUE BETWEEN COMPANY AND SHAREHOLDER.

DIRECTORS UNDERSTANDING INTERESTS AND CONCERNS OF SHAREHOLDERS.

SHAREHOLDERS UNDERSTANDING WHAT THE COMPANY IS TRYING TO ACHIEVE.

INCREASED SHAREHOLDER INTEREST ENCOURAGING CHECKS ON MANAGERS OF COMPANY.

POTENTIAL BENEFITS FROM CLOSER INTEREST BY MAJOR SHAREHOLDERS IN COMPANY AFFAIRS.
Disclosure: best practice corporate governance requirements
Mandatory versus voluntary disclosure

Test your understanding 1
Annual report

- Chairman and CEO statements regarding company position
- Business review (formerly OFR)
- The accounts
- Governance
- AOB (any other business)
Expansion of disclosure beyond the annual report

- press releases
- management forecasts
- analysts' presentations
- the AGM
- information on the corporate web site
Voluntary disclosure

MOTIVATION

- Accountability
- Attracts investment
- Alignment of objectives
- Stakeholders
- Information asymmetry
- Compliance
- Assurance
A. Governance and responsibility

Corporate social responsibility and corporate governance
Session Content

DEFINITION AND NATURE OF CSR
- CARROLL

CORPORATE SOCIAL RESPONSIBILITY
- STAKEHOLDER THEORY
- CORPORATE CITIZENSHIP
- SHAREHOLDER OWNERSHIP

STAKEHOLDERS
- DEFINITION
- STAKEHOLDER CLASSIFICATION
- STAKEHOLDER RELATIONS
- STAKEHOLDER MOTIVATIONS

IMPACT OF STAKEHOLDER ON CORPORATE GOVERNANCE
Corporate social responsibility (CSR)

CSR refers to organisations considering and managing their impact on a variety of stakeholders.
Nature of CSR (Carrol)

**ECONOMIC**
- SHH return
- Employees salaries
- Customers – quality & price

**LEGAL**
- Base line
- Accepted rule book

**ETHICAL**
- Doing right, just & fair
- Reaffirm social legitimacy
- Beyond previous 2 levels

**PHILANTHROPIC**
- Improve lives of others
- Charitable donations & recreation
- Sponsoring arts & sports
Social responsiveness

- Reaction
- Defence
- Accommodation
- Proaction
CSR strategy development

1. Identify Stakeholders
2. Classify Stakeholders
3. Establish Stakeholders’ Claims
4. Assess Importance of Stakeholders (MENDELOW)
5. Decide upon Response to Social Pressure (CARROLL’S STRATEGIES)
Stakeholders and claims

any person or group that can affect or be affected by the policies or activities of an organisation

Traditional model
- Shareholders
- Customers
- Suppliers
- Employees

Stakeholder model
- Government
- Civil society
- Competitors

Claims:
- Direct
- Indirect
Stakeholder classifications

- Internal & external
- Narrow & wide
- Primary & secondary
- Active & passive
- Voluntary & involuntary
- Legitimate & illegitimate
Stakeholder mapping: Mendelow

- **Power**
  - Low: Minimal effort
  - High: Keep satisfied

- **Level of interest**
  - Low: Keep informed
  - High: Key players
Assessing stakeholder importance

- Power
- Legitimacy
- Urgency

- Definitive
- Latent
Organisational motivations regarding stakeholders

**Instrumental view:**
- To not do so would have an impact on primary objectives of organisation
- Devoid of any moral obligation

**Normative view:**
- Moral duty towards others
- Act in general sense of what is right
Impact of stakeholder on CG

• Ethical accounting
• Environmental accounting
• Social accounting
• Sustainability accounting
Corporate citizenship

Answerability for consequences of actions beyond relationship with SHH

Government failure
- risks beyond the control of single government
- electoral impact
- being part of the problem
- too difficult to change lifestyles
- sub-political activism

Corporate power
- liberalisation and deregulation of markets
- privatisation of previous state monopolies
- struggle with unemployment
- pressure on low-wage economies
- complex cross-border legal agreement

Scope: ✓ Limited view ✓ Equivalent view ✓ Extended view
# Shareholder ownership, property and responsibilities

## Ownership & property
- Right to use
- Right to regulate else’s use
- Right to transfer rights
- No damage to others

## SHH rights
- ✓ sell stock
- ✓ vote in general meeting
- ✓ right to certain information about the company
- ✓ sue for misconduct
- ✓ residual rights in the case of liquidation

## SHH responsibilities
- ✓ Shareholder democracy
- ✓ Shareholder activism
- ✓ Ethical investment

## Large corporation
- do not own the organisation – ownership to a limited degree
- Risk - liability
- Reward - value of share/div

---

**Generally**

**Large corporation**

**SHH rights**

**SHH responsibilities**
E. PROFESSIONAL VALUES AND ETHICS

Ethical theories
Session content

Ethical Theories

- Absolutism/Relativism
  - Absolutism
  - Relativism

- Deontological/Teleological
  - Individual
  - Corporate
  - Cultural Context

Kohlberg: Cognitive Moral Development

Gray, Owen & Adams: Positions on Social Responsibility
## Approaches to ethics

<table>
<thead>
<tr>
<th>Absolutism</th>
<th>Relativism</th>
</tr>
</thead>
<tbody>
<tr>
<td>unchanging and immutable set of moral rights or precepts</td>
<td>wide variety of ethical beliefs and practices</td>
</tr>
<tr>
<td>hold true in all situations</td>
<td>‘correct’ depend on the conditions at the time</td>
</tr>
<tr>
<td>common to all societies</td>
<td></td>
</tr>
</tbody>
</table>

**DOGOMATIC APPROACH**

one truth for all situations

**PRAGMATIC APPROACH**

best route in specific situation
Deontological and teleological approaches
# Kohlberg’s cognitive moral development (CMD) theory

## Reasoning process behind moral judgements

## Individual's perspective

<table>
<thead>
<tr>
<th>Level</th>
<th>Stage</th>
</tr>
</thead>
<tbody>
<tr>
<td>3: Post-conventional</td>
<td>3.2: Universal ethical principles</td>
</tr>
<tr>
<td></td>
<td>3.1: Social contract &amp; individual rights</td>
</tr>
<tr>
<td>2: Conventional</td>
<td>2.2: Social accord and system maintenance</td>
</tr>
<tr>
<td></td>
<td>2.1: Interpersonal accord and conformity</td>
</tr>
<tr>
<td>1: Pre-conventional</td>
<td>1.2: Instrumental purpose and exchange</td>
</tr>
<tr>
<td></td>
<td>1.1: Obedience and punishment</td>
</tr>
</tbody>
</table>
Gray, Owen and Adam’s: Seven positions on social responsibility

Positions on social responsibility

- Pristine capitalist
- Expedients
- Proponents of social contract
- Social ecologist
- Socialist
- Radical feminist
- Deep ecologist

Shareholders rule

All stakeholders in partnership
Variables determining cultural context

Cultural differences
Ethical stances

- Short-term shareholder interests
- Long-term shareholder interests
- Multiple stakeholder obligations
- Shaper of society
## Ethical stances

<table>
<thead>
<tr>
<th>Theory</th>
<th>Corporate stance</th>
<th>Personal stance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term shareholder interests</td>
<td>• Must provide an adequate return to its shareholders.</td>
<td>• Small shareholders require annual return on investment.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Larger investors have little short-term interest in the organisation.</td>
</tr>
<tr>
<td>Long-term shareholder interests</td>
<td>• Must maintain its existence.</td>
<td>• Concerned about security of investment.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Require capital growth.</td>
</tr>
<tr>
<td>Multiple stakeholder obligations</td>
<td>• Identify stakeholders with high power and influence over the organisation and attempt to satisfy their objectives.</td>
<td>• Each stakeholder group expects their interests to be understood and acted on.</td>
</tr>
<tr>
<td>Shaper of society (dealing with public interest obligations to society)</td>
<td>• Change society, by applying its own positional power, either for corporate or social benefit.</td>
<td>• Individually, little can be done to shape society.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• As a group, individuals can affect organisations by the choices that are made.</td>
</tr>
</tbody>
</table>
E. PROFESSIONAL VALUES AND ETHICS

Ethical decision making
Session content
Ethical decision making

1. Ethics knowledge
2. Ethical sensitivity
3. Ethical judgement
4. Ethical behaviour
Ethical decision making

- Application of ethical decision making
- Framework for ethical teaching
  - American Accounting Association model
  - Tucker's 5-Question model
American Accounting Association Model

7 questions in the model:

1. What are the facts of the case?
2. What are the ethical issues of the case?
3. What are the norms, principles and values related to the case?
4. What are the alternative courses of action?
5. What is the best course of action that is consistent with the norms, principles and values identified in step 3?
6. What are the consequences of each possible course of action?
7. What is the decision?
Tuckers 5 question model

The decision should be:

- Profitable
- Legal
- Fair
- Right
- Sustainable or environmentally sound
Stages of ethical decision making

STAGE OF...

- Recognise moral issue.
- Make moral judgement.
- Establish moral intent.
- Engage in moral behaviour.

ETHICAL DECISION MAKING

- Lying about products can increase sales.
- Realise that lying to customers is wrong.
- Decide to be honest.
- Tell the truth.

EXAMPLE OF CAR SALESPERSON
Ethical behaviour

ISSUE-RELATED FACTORS
- Moral intensity
- Moral framing.

CONTEXT-RELATED FACTORS
- Rewards
- Authority
- Bureaucracy
- Work roles
- Norm/culture
- National context.
Moral intensity factors

- **Concentration of Effect**
  - Whether effects of action are concentrated on a few people or affect many people a little.
  - E.g. concentration on a few increases intensity.

- **Proximity**
  - The nearness the decision maker feels to people affected by the decision.
  - E.g. being ‘nearer’ increases intensity.

- **Temporal Immediacy**
  - How soon the consequences of any effect are likely to occur.
  - E.g. long time delay lowers intensity.

- **Factors Affecting Moral Intensity**
  - **Magnitude of Consequence**
    - Sum of the harms or benefits impacted by the problem or action.
    - E.g. financial loss caused by faulty advice.
  - **Social Consensus**
    - Degree to which people agree over the ethics of a problem or action.
    - E.g. act deemed unethical by others.
  - **Probability of Effect**
    - The likelihood that harms (or benefits) will actually happen.
    - E.g. higher probability = higher intensity.
Moral framing

Language in which moral issues are discussed in the workplace

- morals are discussed openly
- use of moral words
- ‘moral muteness’
E. PROFESSIONAL VALUES AND ETHICS

Social and environmental issues
Session content

- Social and Environmental Issues
  - ‘Footprints’
  - Sustainability
    - TBL/“Full Cost” Accounting
    - EMAS
    - ISO 14000
  - Management Systems
  - Social and Environmental Audits
Definitions

**Sustainable development** is development that meets the needs of the present without compromising the ability of future generations to meet their own needs

**Sustainability** is an attempt to provide the best outcomes for the human and natural environments both now and into the indefinite future

**Triple Bottom Line (TBL) of John Elkington**

- Economic perspective
- Social perspective
- Environmental perspective
Brundtland Commission

1. Provide environmental strategies for achieving sustainable development to the year 2000 and beyond.

2. Recommend ways in which concern for the environment can be translated into co-operation on environmental issues.

3. Consider ways in which the environmental community can deal more effectively with environmental concerns.

4. Provide methods of protecting and enhancing the environment in the long-term.
Effects of economic activity

Economic activity

Social footprint
- social capital
- human capital
- constructed capital

Environmental footprint
- resource consumption
- harm to environment by pollution
- qualitative, quantitative or replacement terms
# Measuring sustainability

<table>
<thead>
<tr>
<th>Quotients approach</th>
<th>Subjective approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>amount of resource available compared with actual use of that resource.</td>
<td>Measures intentions of organisations to achieve certain goals or objectives.</td>
</tr>
<tr>
<td>Similar concept to TBL method of accounting, as it provides a quantifiable method of checking social and environmental footprints.</td>
<td>Lack of quantification means that ‘progress’ can be made towards the intention, although difficult to determine how much progress has been made or whether that progress is sustainable.</td>
</tr>
<tr>
<td>For example, water usage can be compared with the amount of fresh water being generated. If usage &gt; generation then the activity is not sustainable.</td>
<td>For example, the Millennium Development Goals of the United Nations have statements such as ‘ensure environmental stability’.</td>
</tr>
<tr>
<td>Progress towards sustainability can be measured by comparing water usage over a period of time – the activity becoming sustainable where usage is less than production.</td>
<td>‘Progress’ can be made towards this in terms of reducing carbon emissions. However, the exact reduction will be unclear while reduction may have other negative impacts (e.g. increase resource use in other areas).</td>
</tr>
</tbody>
</table>
Measuring sustainability

\[
\text{USE OF ENVIRONMENTAL RESOURCE} = \frac{\text{PRODUCTION OF ENVIRONMENTAL RESOURCE}}{\text{NEED FOR SOCIAL CAPITAL}} = \begin{cases} \text{RESULTS} > 1 & \text{UNSUSTAINABLE} \\ \text{RESULTS} < 1 & \text{UNSUSTAINABLE} \end{cases}
\]
Accounting for sustainability

‘FULL COST’ ACCOUNTING
TRIPLE BOTTOM LINE (TBL)

- ECONOMIC OBJECTIVES
- ENVIRONMENTAL OBJECTIVES
- SOCIAL OBJECTIVES

### Full cost
- total cost of company activities (incl. environmental, economic & social costs)
- all the costs of an action, decision or manufacture of a product
- aim – to internalise all costs (even those, incurred outside)

### Triple Bottom Line
- expanding the traditional company reporting framework
- People, Planet and Profit
Management systems

- **EMAS**
  Focus on disclosure of environmental systems.

- **ISO 14000**
  Focus on compliance with internal environmental systems.
Management systems

**EMAS**
- voluntary initiative
- participants regularly produce public environmental statement
- accuracy and reliability independently checked by environmental verifier
- requires implementation of environmental management system (EMS)

- Legal requirement
- Dialogue/reporting
- Improved environmental performance
- Employee involvement

**ISO14000**
- series of standards
- ISO formulates the specifications for an EMS
- EMAS compliance is based on ISO 14000 recognition
- focuses on internal systems
- to gain accreditation an organization must meet a number of requirements
Social and environmental audit
Social & environmental auditing

Social auditing

- assessing the impact of organisation on the environment.
- involves implementation of appropriate environmental standards (ISO 14001 & EMAS).
- provides raw data for environmental accounting.

Environmental auditing

- contains three elements:
  - agreed metrics (what & how)
  - performance measured
  - reporting

Evaluating the organisation’s footprint
Environmental accounting

Development of an environmental accounting system to support the integration of environmental performance measures

Aims:
- use metrics (environmental audit) & incorporate into environmental report
- integrate environmental performance measures into core financial processes

Benefits:
- Cost savings
- Environmental improvements
- Corporate governance
Social and Environmental reporting

Except in some highly regulated situations (such as water), the production of a social and environmental report is voluntary.

The problem – what should be the typical contents of such a report and how do we measure it.

Frameworks do exist, such as the data gathering tools and the ISO14000 collection of standards, but essentially there is no underpinning compulsion to any of it.
Social and Environmental Reporting

**Environmental reporting**
- disclosure of information on environment related issues and performance by an entity
  - measures of emissions
  - consumption
- annual report
- self standing report

**Social Reporting**
- human rights issues
- workplace, occupational health and safety
- training and employee issues
- fair pay for employees and suppliers
- fair business practices
- minority and equity issues
- marketplace and consumer issues
- community involvement
- indigenous peoples
- social development
- charitable, political donations and sports sponsorship
S&E Reporting – Why bother?

- stakeholders want to know
- more aware of the potential risk
- the ethical performance of a business is a factor in some investor's decision to invest.
- employees may use ethical performance as a criterion in their choice of potential employer
- some consumers will not buy goods or services from unethical companies
- voluntary disclosure may pre-empt regulatory intervention
- provide an impetus for internal development and a higher level of Corporate Governance
B  INTERNAL CONTROL AND REVIEW

Internal control systems
Session Content

Diagram: Session Content Flow

- Definitions
- Internal Control Systems
  - Objectives
  - Sound Control Systems
  - Roles
  - Review Effectiveness
  - Management Information Flows
  - COSO
  - Characteristics of Information
- Limitations
Development

- Cadbury Report (1992)
- COSO (1992)
Objectives of an internal control system - APB

includes all the policies and procedures (internal records) adopted by the directors and management of an entity to succeed in their objective of ensuring, as far as practicable:

- Orderly and efficient conduct, including adherence to internal policies
- Safeguarding assets
- Prevention / detection of fraud & error
- Accuracy and completeness of records
- Timely preparation of financial information
Objectives of an internal control system - COSO

a process, effected by the entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations

internal control is a process
provides only reasonable assurance
effectiveness and efficiency of operations (not only financial reporting and compliance)
achievement of performance objectives
Limitations

⚠ cannot turn a poor manager into a good one
⚠ reasonable assurance
⚠ can be by-passed by collusion and management override
⚠ designed to cope with routine transactions and events
⚠ resource constraints
Sound control systems

- Embedded within operations and not treated as a separate exercise.
- Able to respond to changing risks within and outside the company.

Sound internal control system

Includes procedures for reporting control failings or weaknesses
Roles

- Ensuring adequacy and effectiveness of internal control system.
  - Setting internal control policies
  - Monitoring effectiveness of internal control system.

- Establishing specific internal control policies and procedures.

- Operating and adhering to internal controls.

- Responsibility:
  - Board of Directors
  - Senior Executive Management
  - Heads of Business Units
  - All Employees
Internal Control System

- Control environment
- Control activities
- Risk assessment
- Monitoring of controls
- Information & Communication
Control environment

“Tone at the top”:

- Integrity, ethical values, behavior of key executives
- Management commitment to competence
- Competence of personnel
- Management philosophy
- BOD participation in CG
- Organizational structure
- HR policies & practices
- Assignment of authority and responsibility
Risk assessment

Consider:

- internal factors
- external factors

Distinguish between:

- controllable risks
- not controllable risks
Control activities

- Segregation of duties
- Physical
- Authorisation & approval
- Management
- Supervision
- Organisation
- Arithmetic & accounting
- Personnel

Group 1
Group 2
Group 3
Management levels

- Strategic
- Tactical
- Operational

Planning activities

Control activities
Information systems
Information characteristics and quality

A – Accurate
C – Complete
C – Cost-effective
U – Understandable
R – Relevant
A – Accessible
T – Timely
E – Easy-to-use!
# Information characteristics and quality

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Strategic</th>
<th>Operational</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time period</td>
<td>Forecast</td>
<td>Historical</td>
</tr>
<tr>
<td>Timeliness</td>
<td>Delayed</td>
<td>Immediately available</td>
</tr>
<tr>
<td>Objectivity</td>
<td>Subjective</td>
<td>Objective</td>
</tr>
<tr>
<td>Quantifiability</td>
<td>Qualitative</td>
<td>Quantitative</td>
</tr>
<tr>
<td>Accuracy</td>
<td>Approximate</td>
<td>Accurate</td>
</tr>
<tr>
<td>Certainty</td>
<td>Uncertain</td>
<td>Certain</td>
</tr>
<tr>
<td>Completeness</td>
<td>Partial</td>
<td>Complete</td>
</tr>
<tr>
<td>Breadth</td>
<td>Broad</td>
<td>Specific</td>
</tr>
<tr>
<td>Detail</td>
<td>Little detail</td>
<td>Highly detailed</td>
</tr>
</tbody>
</table>
Audit and compliance
Function and importance of internal audit

- Internal Audit
  - Management control
  - Part of control systems
  - Statutory requirement / strongly suggested
Roles of internal audit

- Reviewing accounting and internal control systems.
- Examining financial and operating information.
- Assisting with the identification of significant risks.
- Special investigations, e.g. into suspected fraud.
- Reviewing the economy, efficiency and effectiveness of operations.
- Reviewing compliance with laws and other external regulations.
Types of internal audit work

- financial audit
- operational audit
- project audit
- value for money / best value audit
- social and environmental audit
- management audit.
Factors affecting need for internal audit

- Scale, diversity and complexity of company’s activities
- Number of employees
- Cost / benefit
- Changes in organisational structures
- Changes in key risks
- Problems with existing internal control systems
- Recent ‘events’
Risks if auditors are not independent

- Fail to report control breaches.
- Ignore discrepancies.
- Back down on matters of principle.
- Accept explanations without checking.
- Turn a blind eye to unethical practices.
- Give undeserved positive feedback.
Threats to independence

- **Self-interest**: Auditor could benefit from financial interest in client.
- **Familiarity**: Auditor becomes too ‘friendly’ with client by working for client for a number of years.
- **Advocacy**: Auditor promotes an audit client’s position or opinion.
- **Self-review**: Auditor in position of reviewing work they have been responsible for.
- **Intimidation**: Auditor is subjected to intimidation.
Protection of independence

- Independence of executive management
- Direct reporting
- Appointment / termination

- Attribute standards
  - Independence
  - Objectivity
  - Professional care

- Performance standards
  - Managing internal audit
  - Risk management
  - Control
  - Governance
  - Internal audit work
  - Communicating results
Audit committee roles

ROLES OF THE AUDIT COMMITTEE

- Review of internal control systems
- Oversee work of internal audit
- Monitor integrity of financial statements
- Review work of external audit
Audit committee: internal control

- Review the company’s internal financial controls
- Review all the company’s internal control and risk management systems
- Review compliance with regulations, legislation and ethical practices
- Review the company’s fraud risk management policy
- Give approval to internal control and risk management statements in annual report
- Receive reports from management about effectiveness of control systems
- Receive reports on tests carried out on controls by internal & external auditors
- Supervise major transactions
Audit committee: internal audit

AUDIT COMMITTEE ROLE IN OVERSEEING INTERNAL AUDIT FUNCTION

- Monitor and assess the annual internal audit work plan.
- Review and assess effectiveness.
- Ensure accountable to the audit committee.
- Ensure recommendations are actioned.
- Check efficiency.
- Approve the appointment or termination of head of internal audit.
- Preserve independence.
Audit committee duties: external audit

- Recommendation on appointment, re-appointment and removal of auditors
- Oversee selection process
- Approve terms of engagement and remuneration
- Ensure independence and objectivity
- Review scope of audit
- Ensure appropriate plans at start of audit
- Carry out post-completion audit review (level of errors, key accounting judgements, discussion)
Reporting on internal controls to shareholders

- Shareholders entitled to know whether the internal control system is sufficient to safeguard their investment.
- Board should conduct a review of the effectiveness & report.
- Review – cover all material controls.
- Review against COSO's elements.
- Annual report inform members of work of audit committee.
- Chair of the audit committee available at the AGM.
- Additional reporting requirements apply under SOX.
E. PROFESSIONAL VALUES AND ETHICS

Professional and corporate ethics
Session content

PROFESSIONAL AND CORPORATE ETHICS

PROFESSION VS PROFESSIONALISM
PUBLIC INTEREST
ACCOUNTANTS’ ROLE AND INFLUENCE

CORPORATE ETHICS
CORPORATE CODES

PROFESSIONAL CODES OF ETHICS
ACCA CODE: CONTENT AND PRINCIPLES
CONFLICTS OF INTEREST AND THREATS
SAFEGUARDS
Profession vs professionalism

- 'Profession'
  - Body of theory and knowledge
  - To support the public interest

- 'Professionalism'
  - Taking action
Profession

- Body of theory and skills
- Adherence to common code of values and conduct
- Acceptance of duty to society
Professionalism

- members are seen to be acting professionally
- a state of mind (profession provides the rules)
- professional behaviour = obligation on members to comply with laws & regulations and avoid any action that may bring discredit to the profession
- professional behaviour = complying with the ethical standards laid down by the professional body.
Public interest

The accountancy profession’s public:

✓ clients
✓ credit providers
✓ governments
✓ employees
✓ employers
✓ investors

Public Interest – that which supports the good of society as a whole

- Public interest versus human rights
- Public interest and companies
- Public interest and legal cases
Accountants’ role and influence

Diagram:

- Accountancy
  - Influence on organisations
    - Provision of services
  - Influence on society
    - Act in public interest
  - Influence on distribution of power and wealth
    - Use of specialist skills
Limits on influence of accounting on organisations.

Limits

- Extent of organisational reporting
- Conflicts of interest in selling services
- Long-term relationship with clients
- Overall size of accountancy firms
- Focus on growth and profit
Influence in society

- act in the public interest
- may not be trusted fully due to past failings
- barriers ⇒ avoid change & maintain status quo
- have knowledge to involve in new initiatives
Influence on power and wealth distribution
Corporate ethics
Professional practice and codes of ethics

PROFESSIONAL CODE OF ETHICS

Content
- Who is affected?
- Fundamental principles
- Guidance on how to apply.

Principles
- Main principles to be followed by all members/students.
Principles

**Integrity**
Members should be straightforward and honest in all professional/business relationships.

**Objectivity**
Members do not allow bias or conflict of interest in business judgements.

**Competence**
Duty to maintain professional knowledge and skill at appropriate level.

**Confidentiality**
Information on clients not disclosed without appropriate specific authority.

**Professional behaviour**
Members must comply with relevant laws and avoid actions discrediting the profession.
Conflicts of interest and ethical threats

- Conflicts of interest
  - Self-interest
  - Self-review
  - Advocacy
  - Familiarity
  - Intimidation

- Safeguards
  - Profession
  - Work environment
  - Individual

- Conflict resolution
  - Obtain all necessary information.
  - Consider courses of action.
## Safeguards

<table>
<thead>
<tr>
<th>Safeguards created by the profession</th>
<th>Safeguards in work environment</th>
<th>Safeguards created by Individual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education requirements for entering into profession</td>
<td></td>
<td>• complying with CPD requirements</td>
</tr>
<tr>
<td>Continuing professional development (CPD)</td>
<td>• strong internal controls</td>
<td>• keeping up to date with professional standards</td>
</tr>
<tr>
<td>Corporate governance requirements</td>
<td>• consultation with another professional accountant in areas of uncertainty</td>
<td>• maintaining contact with the ACCA</td>
</tr>
<tr>
<td>Professional standards (e.g. the IFAC Code of Ethics and the IAASB’s ISAs)</td>
<td>• each employer should have a visible ethical leadership</td>
<td></td>
</tr>
</tbody>
</table>
Ethical threats and safeguards

- Inducements - Giving and Receiving
- Preparation and Reporting on Information
- Sufficient Expertise
- Confidential Information
- Conflicts between employer and fundamental principles
- Financial interests
- Whistleblowing
Approaches to conflict resolution
Ethical conflict resolution

- Gather facts
- Establish ethical issues
- Refer to fundamental principles
- Flow internal procedures
- Investigate alternative courses of action
- Consult within firm
- Obtain advice from institute
- Withdraw from role
What is Corruption?

Corruption is.............bribery and any other behaviour in relation to persons entrusted with responsibilities in the public or private sector which violates their duties and is aimed at obtaining undue advantages of any kind for themselves or for others.

The main forms of corruption are:
- Bribery /facilitation payments/”excessive” hospitality
- Embezzlement
- Fraud and
- Extortion.
Why is corruption wrong?

The ethical argument-

Corruption is inherently wrong:
The reality that laws making corrupt practices criminal may not always be enforced is no justification for accepting corrupt practices. To fight corruption in all its forms is simply the right thing to do.

The business arguments-

- Legal Risks
- Reputational Risk
- Financial Cost
- Pressure to repeat offend
- Blackmail
- Impact on staff
- Impact on development
Relevant Legislation

- The US Foreign and Corrupt Practices Act (1977)
- The UN Convention against Corruption (2003)
- The UK Bribery Act (2010)
Assessing risk exposure

- The particular country you want to do business in,
- The sector which you are dealing in,
- The value and duration of your project,
- The kind of business you want to do and
- The people you engage to do your business.
Evaluating anti-bribery and corruption (AB&C) procedures

- Proportionality
- Top-level commitment
- Risk assessment
- Communication
- Due Diligence
- Monitoring and review
Barriers to AB&C policies implementation

- Competitive advantage
- Managerial apathy
- Off-the-shelf solutions
- Corporate structures
- "Shadow" hierarchies
- Excessive pressure to hit targets
- Cultures of secrecy
- Heterogeneous cultures
Risk and the risk management process
Necessity of risk and risk management

- **INCUR RISK TO**
  - GAIN COMPETITIVE ADVANTAGE.
  - INCREASE FINANCIAL RETURN.

**ALARP**

**Activity risk**

<table>
<thead>
<tr>
<th>Ability to gain competitive advantage</th>
<th>Low</th>
<th>High</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>2 Routine</td>
<td>4 Avoid</td>
</tr>
<tr>
<td>High</td>
<td>1 Identify and develop</td>
<td>3 Examine carefully</td>
</tr>
</tbody>
</table>
Risk management process

PROCESS OF RISK MANAGEMENT

- Risk Identification
- List of potential risks
- Risk analysis
- Prioritised risk list
- Risk planning
- Risk avoidance and contingency plans
- Risk monitoring
- Risk assessment
Enterprise Risk Management (ERM)

‘process effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.’

Principles:

- consideration of risk management in the context of business strategy
- risk management is everyone’s responsibility, with the tone set from the top
- the creation of a risk aware culture
- a comprehensive and holistic approach to risk management
- consideration of a broad range of risks (strategic, financial, operational and compliance)
- a focused risk management strategy, led by the board
COSO ERM framework matrix

Benefits of effective ERM include:

- enhanced decision-making
- improvement in investor confidence
- focus on the most significant risks
- a common language of risk management
- reduced cost of finance
Strategic and operational risk

- **RISK**
  - CATEGORISED BY
  - **STRATEGIC**: AFFECTS THE OVERALL MISSION OF THE COMPANY.
  - **OPERATIONAL**: AFFECTS THE DAY-TO-DAY ACTIVITIES OF THE COMPANY.
Risks facing a business (ACCA’s)
Sector-specific risks

- **Generic**: Affects all businesses.
- **Specific**: Affects individual businesses.
Related risk factors

**CORRELATION BETWEEN RISK**

**POSITIVE CORRELATION**
Both risks move in the same direction
For example:
As the Environmental risk increases so does the Reputational risk

**NEGATIVE CORRELATION**
Each risk moves in an opposite direction.
For example:
As more money is spent on reducing the Environmental damage, therefore reducing the risk. There is an increase in the financial risk facing the company.
Impact on stakeholders
Analysing risks

- Risk
- Categorised by
  - Severity: The impact of the risk on the organisation.
  - Probability: The likelihood of the risk actually occurring.
Risk mapping
Dynamic nature of risk assessment

- **STATIC**
  - Nothing in the internal environment changes
  - Nothing in the external environment changes
  - Risks facing the business never change

- **DYNAMIC (turbulent)**
  - Internal activities constantly changing (e.g. product launches, financial restructuring)
  - External environment changes (e.g. customer requirements, resource supplies)
  - Risks facing the business are always changing
Risk perception

DIFFERENT RISK PERCEPTIONS

OBJECTIVE
Assessment made with high degree of certainty

SUBJECTIVE
Very difficult to assign value to impact & likelihood
Controlling risk
Role of the board
Risk appetite

Risk attitude
  - Risk averse
  - Risk seeking

Risk capacity
Risk appetite factors

- Nature of product
- Need to increase sales
- Background of board
- Market change
- Reputation
Risk attitudes

RISK ATTITUDE VARIES WITH ORGANISATIONAL

SIZE  STRUCTURE  DEVELOPMENT
Risk committee aims

- Update risk profile & appetite
- Process to monitor & report risk
- Policies for risk management
- Risk awareness
- EDs & NEDs
Risk committee tasks

- Assess risk management procedures
- Emphasise & demonstrate benefits of risk-based approach to IC
- Consider risk audit reports on key business areas → assess exposure
- Assess risks of any new ventures & other strategic initiatives
- Review credit risk, interest rate risk, liquidity risk and operational risk exposures with regard to full board risk appetite
- Public disclosure – in accordance with statutory requirement & standards?
- Make recommendations to the full board on all significant matters relating to risk strategy and policies.
The risk manager

- Member of Risk Committee
- Implements Risk Management Policies
- Operational Role
Risk awareness

**Strategic**
- High level monitoring
- Risks affecting organisation as a whole
- Lack ⇒ behind competitors / existence?

**Tactical**
- Monitoring at divisional level
- DivS: lack – continuity of supply / availability of distribution channels
- FuncS: lack – continuity of process completion
- Resignation risk – motivation monitoring

**Operational**
- Monitoring risk in day-to-day operations
- Lack – unlikely a specific threat initially
- Continued errors or risk – add reputation risk over time
Embedding risk

- In systems
- In culture
Embedding risk in systems

- Control systems include risk management.
- Risk management not a separate system.
- Needs board support.

Process:
- Identify existing controls
- Monitor them
- Improve & refine
- Document evidence
Embedding risk in culture

Embedding Risk in Culture

- IMPLIES RISK MANAGEMENT IS 'NORMAL' ACTIVITY.
- SUCCESS DEPENDS ON ORGANISATIONAL CULTURE.
- MAIN EMPHASIS – LACK OF BLAME CULTURE.

Methods

- Aligning goals
- Job descriptions
- Reward systems
- Metrics & performance indicators
- Informing staff
- Success stories
Risk management strategies - TARA

- Transference (or Sharing)
- Avoidance
- Acceptance
- Reduction
Risk mapping and risk management strategies

- **Impact/Consequence**
  - Low
  - High

- **Probability/Likelihood**
  - Low
  - High

- **Response Strategies**
  - Reduce
  - Avoid
  - Accept
  - Transfer
Risk avoidance and retention
Diversifying / spreading risk

DIVERSIFYING/SPREADING RISK

- AIM TO REDUCE TOTAL RISK.
- CAN DIVERSIFY OPERATIONS.
- WORKS BETTER WHERE NEGATIVE CORRELATION IS EVIDENT.
Types of diversification

- **Backward Integration**: E.g. raw materials supplier
- **Forward Integration**: E.g. distribution outlet
- **Related**: Development beyond the present product and market, but still within the broad confines of the 'industry'.
- **Unrelated**: Development beyond the present industry into products and/or markets that may bear no clear relationship to their current products.
- **Horizontal Integration**: E.g. competitor
Ansoff’s product/market matrix

- **Present**
  - Market Penetration

- **New**
  - Product Development

- **New**
  - Market Development

- **Present**
  - Diversification
Risk auditing

- Assists risk monitoring process.
- Provides 'fresh pair of eyes'.
- May be a statutory requirement.
Internal vs external audit

**Internal audit**
- Management responsibility – internal function
- Familiarity with culture, systems, procedures & policies
- Flexibility of internal teams
- Work more relevant for intended use

**External audit**
- Comply with IFAC’s (and ACCA’s) code of ethics
- Higher degree of confidence for investors and regulators
- Fresh pair of eyes to the task
- Best practice and current developments can be introduced
Stages of a risk audit

1. Identify Risks
2. Assess Risks
3. Report on inadequately-controlled risks
4. Review Controls over Risk

PROCESS FOR CARRYING OUT INTERNAL RISK AUDIT
External reporting

EXTERNAL REPORTING: INTERNAL CONTROLS + RISKS

PROCESS

IDENTIFY REPORTING SITUATION
Internal control failure/directors making inappropriate decisions (as in Enron).

CHECK COMPLIANCE WITH LEGISLATION/ETHICAL GUIDANCE
Companies Act/stock exchange requirements/professional ethical guidelines may require disclosure.

MAKE REPORT IF REQUIRED
Document reason for report (e.g. qualified audit/report whistleblowing) and make report to appropriate third party.