QUESTION 1:

Indicative content

(a) CSR

CSR generally refers to business decision-making linked to ethical values, compliance with legal requirements and respect for people, communities and the environment. Because a firm’s viability is framed by the social environment which it operates, the firm should contribute to the betterment of the society that has played a part. However, since these expenses and benefits cannot be directly attributable to any single source, some firms would explicitly establish a CSR policy so that such goodwill would at least be recognised.

Examples where CSR has not been practiced could include:

- Misleading advertising of prices for customers
- Slow payment of suppliers and disputing amounts because simply overdue
- Using factories in countries with laxer health and safety standards
- Evasion of consultation with local communities concerning developments likely to be unwelcome.

Companies should disclose their CSR policies as the resulting transparency will allow for a better assessment of the decision making and implementation process.

(b)

Cadbury UK 1992
non-executive directors, split of chairman and CEO roles, financial internal controls

Greenbury UK 1995
remuneration committee and policy, one-year service contracts, performance related pay

Hampel UK 1998
board composition and committees, greater shareholder involvement, need to strengthen risk management beyond financial

Turnbull UK 1999
risk in the widest sense, looks to future as well as past, strategic issues, regular reviews and adaptation, disclosure
Higgs UK 2003
comply or explain, independence of NEDs, board effectiveness, role of the secretary

Smith UK 2003
auditors, audit committees

(c) OFR

Report in simple language, usually in the annual report and accounts, describing the company’s operations, financial position and performance for the period under review. Covers qualitative as well as quantitative factors and future strategies and expectations as well as past.

Already a requirement in the US, it may become a statutory requirement for large companies in the UK in the near future.

(d) Institutional shareholders

Dialogue with companies based on ‘mutual understanding of objectives’

Evaluating the corporate governance disclosures by companies
- Give due weight to all relevant factors drawn to their attention
- Make reasoned judgements of each explanation given
- If they disagree, explain in writing to the company
- Avoid a ‘box-ticking’ approach in checking compliance
- Bear in mind the size and complexity of the company
- Ensures their companies have a statement as to whether the issuer meets the Code Provisions
  - A separate corporate governance report
  - Others like separation of chair and CEO

Shareholder voting
- Considered use of their votes
- Efforts to ensure that proxy appointments take place as intended
- Make available results to beneficial owners
- Attend AGMs where ‘appropriate and practical’

(e) Stakeholders

TWO with some explanation from:
- Financial reporting and auditing
- Directors’ remuneration
- Decision making powers within the company, centralisation or devolution
- Risk taking
- Communications – or lack thereof
Especially between suppliers whereby one of the directors is somehow associated with the suppliers (see independence rule)

(f) Nomination committee

- Identify candidates to fill vacancies on the board from a wide range of backgrounds
- removal
- Evaluate the balance of skills, knowledge and experience of the board and prepare description of the needs for each appointment and make recommendations for changes required
- Review the time required of each NED
- Succession planning
- Annual report including any external advice sought, membership, attendance
- Review leadership in light of market and competitors
- Placement of directors into committees
- Orientation and training of directors
- Evaluating performance of the directors (not mandatory yet)

Sometimes remuneration is discussed if the remuneration committee does not exist.

(g) Fairness

- Equal consideration for each shareholder, regardless whether they are majority or minority shareholders
- Protection of the rights of minorities
- Provision of information on a timely basis
- Access to general meetings and voting arrangements

(h) Website

Provide ready accessibility to:

- Notices of general meetings, arrangements for appointing proxies, arrangements for those attending meetings
- Annual report and accounts, preliminary results, interim statements
- Presentations to analysts, institutional shareholders and the AGM
- Press releases and official announcements
- General information on the company and its business
- Links to share price, dealing information, records of past prices.

(i) Company secretary’s independence

In order to expect impartial advice from the company secretary, boards should ensure that the secretary is in a position to do so. Policies and procedures to cover situations where the secretary’s authority would be challenged should be in place. For example, how to
minute any potential areas of conflicts or dissenting views. As an officer, report through the chairman to the board as a whole

Any additional executive responsibilities, report to the chief executive or appropriate executive directors on such matters.

Secretary’s remuneration should be settled (or at least noted) by the board as a whole or by the remuneration committee on the recommendation of the chairman or chief executive.

Engage independent consultant to provide an assessment of the level of independence and how this is enforced in practice.

(j) Directors’ liability insurance

Directors can be liable for negligence, breach of duty or trust

NEDs especially exposed as cannot know as much as executive colleagues

Possible deterrent to taking office; increased concerns re health and safety legislation and corporate manslaughter. In Hong Kong, the new code stipulates that an issuer should arrange appropriate insurance cover in respect of legal action against its directors. This is a recommended best practice.

Section 165 Companies Ordinance allows companies to purchase insurance for its directors against losses arising from negligence, default, breach of duty or trust and for the costs related to defending these actions (with the exception of cases involving fraud). However the entitlement to these benefits will only accrue if the director is successful in defending the action in court.
QUESTION 2: Shareholders and Directors

‘Critically consider’ requires argument for and against the role concerned. A balanced response would attract more marks but a one-sided response would not necessarily fail.

It should be noted that while the practice of good corporate governance would not by and of itself guarantee sound financial returns it may minimise the extent of downside risks.

The private equity individuals are able to do this mainly because they believe their contribution and their business solutions, added to the current business model, would create a more viable model. They are able to recognize this because of their insight (their own) coupled with information provided by the company which everyone gets. Focusing the business by removing some of the ineffective directors may have contributed to higher profits; finding new business opportunities otherwise not available to the existing shareholders may have attributed to this. There are many reasons for a business success. Having sound corporate governance practices play an important and necessary part, but not sufficient by itself, in creating a ‘sustainable’ entity. For example, the competitive environment in which the firm is in has a lot to do with its profitability.

Indicative content

Private equity:
- Typically a written shareholders’ agreement
- Close control of the board
- Power to appoint and remove the directors
- Explicit list of decisions that must be approved by shareholders

Public companies:
- Articles of Association provide the ‘contract’ with shareholders
- Rules on rotation of directors, re-elected at least every three years, but usually the board nomination and rarely the shareholders’ choice
- Disclosure of directors’ interests
- Split of roles of chairman and chief executive to avoid over-concentration of power
- All directors must take decisions objectively in the interests of the company
- To achieve balance and objectivity there should be a significant number of independent directors
- Nomination committee, appointments on merit and against objective criteria
- Weaknesses: usually draw from a small pool of talent, chairman and chief executive may have undue influence, too many posts per person

Schedule of matters reserved for the board – but not for the shareholders except large enough to be a class transaction under the listing rules or to need a change in the objects clause of the Memorandum

Any further points raised by candidates should be considered by the markers on their merits.
Question 3: Family Business

Indicative content

(a) matters needed by a prospective NED

Recent financial and management accounts
Prospects for the future markets and regulation of the business
Membership of both the board and the company
Whether there are any shareholder agreements in existence
Nature of arrangements with banks and any other providers of finance

(b) governance principles relevant to family companies

- Clarity of roles of management of operations and the policy and strategic role of the board, particularly on position of family members such as the removal of family members when they are incompetent.
- Management of risk and use of formal mechanisms to encourage board and management effectiveness
- Timely reporting to the board of all material matters concerning the business
- Allocating appropriate rewards – different parameters to the remuneration concerns of large companies but also very important
- Integrity in decision making and in reporting, with succession decisions based on merit and skills required
- Upholding rights of shareholders, especially those not involved in management and those in a minority position
- Recognising the legitimate interests of all stakeholders

Merit answers would expand into these as well:

- Be explicit on areas where conflict would eventually develop and have a policy in place before it is needed (e.g. Removal of incompetent family members)
- Providing training on how best to give constructive feedback to each other, even though blood is thicker than water.
- Establish an independent board
- Identify an individual, preferably not a family member, who would represent the final court of appeals and who would arbitrate tied decisions of the board.
- Ensures the board discuss the company’s strategic plan and its family financial plan separately because they can appear to be the same.
- Focus on meritocracy.
- Provide for early exit of directors and investors should they so choose and set this in a policy.
- Ensures the business is a one-family business, not a fiefdom.

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Question 4: Audit Function

Indicative content

(a) Operation of audit function and interaction

Purpose: to make sure that the financial statements are objective and reliable

Reflecting a “true and fair” view of the position of the company

Splits within the company and outside it

Internal: audit committee, internal audit function and internal control processes

External: for objectivity, degree of independence from management

External auditors report to audit committee, including in absence of management
  test control processes before relying on them
  review any reports by internal audit as part of their risk analysis

Internal auditors: should have direct access to the audit committee
  Use, test and help to develop internal controls
  Annual plan reviewed by the audit committee

The philosophy of audit is one of control through a layering process. Each of the parties play a part, providing stronger checks and balances to one where by itself its authorities would be somehow undermined. The layering of audit actually begins from the front line to the Board and each layer plays a part. No manager should rely solely on another party to ensure compliance has been done. The first level of audit belongs to the manager. An effective control system enhances control at every level by enabling every level to do their part.

Should the manager miss something, his supervisor or the financial controller should have a system or policy in place to highlight such discrepancies. The financial controller provides the second layer of control at the front line.

The internal auditor, acting on the authority of the board, provides the third layer of control; while the external auditor, would be providing the fourth layer of control. An effective control system permeates the entire organisation and is used by managers, FC, and others. The system should provide sufficient level of checks and balances at the first instance
(b) contributions to corporate governance

External auditors

Appointed by shareholders, but based on board recommendation
Issues of independence, length of service, partner rotation, other work for the company, subject to auditing standards and professional discipline, SOX
Limitations re fraud and malpractice – assess risk but can only test
Compliance with applicable accounting standards and guidelines that are issued by the Hong Kong Institute of CPA and the Stock Exchange of Hong Kong.

Internal audit

Reviews adequacy of risk management systems and internal controls
Reports on these to audit committee and external auditors as well as management
Assurance on compliance with corporate policies, legislation and regulations
Alert management and audit committee to fraud or other failure or to weaknesses that might allow these to occur

Internal control system

System includes both the control environment and control procedures
Control environment requires awareness of internal controls by directors, management and staff, thus encompassing corporate culture, management style and staff attitudes to control procedures, all of which contribute to a properly managed business accountable to the shareholders
Control procedures and policies include measures to safeguard the assets of a business, to prevent and detect fraud and error, to ensure the accuracy and completeness of accounting records and the timely preparation and circulation of reliable financial information
Reflect sound business practice by being embedded in the business processes by which the company pursues its objectives
Must remain relevant over time as business evolves
Should be applied in a manner relevant to the particular company
Annual review (minimum) in line with Turnbull recommended by Combined Code
QUESTION 5: Share Incentives

Indicative content

Remuneration:
- Remuneration policy and committee help to remove key executives from being involved in setting their own remuneration
- Strong NEDs on remuneration committee can challenge over generous arrangements (cf. Enron off balance sheet partnerships, soft loans)
- Disclosure (provided accurate) can bring pressure to be reasonable because of the need to explain
- Policy must align corporate goals with targets and incentives

Share incentive schemes:
- Stock options give rights, usually at favourable prices, to purchase shares without requiring the director or executive to risk their own money; instead can require them to receive remuneration in shares or otherwise pay for their shares.
- Large blocks of options encourage short term manipulation of results to give favourable share price at a particular time; grant options by drip feed
- Introduce minimum holding periods, but with consideration of the cash flow impact of tax

Proper accounting and control:
- Good internal control system and independent audit minimise the scope for manipulation, or even mis-statement, of results
- Strong NEDs who challenge numbers provided and insist on timely reporting
- Audit committee with majority or all independent NEDs
- Independence and rotation of auditors

Model Code and insider dealing rules:
- Those with price sensitive information should not deal in shares or securities based on the shares (e.g. options, warrants)
QUESTION 6: Dominant Director, Audit and Accountability

Indicative content

(a) key points

Dominant director
- Poor board structure – weak NEDs and no committees
- Ineffective internal controls
- Lack of auditor independence
- Lack of board policies and enforcement of such
- Lack of a separation of roles

(b) application of governance principles to avoid problems

Dominant director:
- Separation of roles of chairman and chief executive
- Concentration of power makes it difficult for usual safeguards such as NEDs and audit to operate properly
- Failure to consider whether proposed transactions were in the interest of the company
- Fraudulent acquisitions of assets from the company and use of assets purchased and maintained by the company as if they were own personal property
- Disclosure of directors’ interests

Board structure:
- Balanced board with strong non-executive challenge to the executives
- NEDs must ensure accountability and consideration of shareholder interests
- NEDs must demand timely and proper information when it is not forthcoming and question any that raise concern about accuracy or reasonableness
- Audit committee would have provided a better check and the opportunity to probe any concerns of the auditors or provide a place for senior management (or others) with concerns about actions to ‘blow the whistle’
- Remuneration committee could have challenged the levels of benefits in kind, or at least in considering total package might have raised some of these issues.

Internal controls:
- Inadequate controls allowed improper payments to be made unchallenged both of loans without back-up documentation, credit checks or evidence of true ownership
- Allowed rigging of the accounts around the balance sheet dates
- An extra mark for reference to money-laundering regulations.
Auditor:

- Inappropriate choice, too small for the type and size of client
- Lack of independence, largest client, hard to challenge dominant director, no audit committee to provide independent access to the board
- Did not properly challenge the documentation of transactions close to the balance sheet dates, especially loans to and from companies controlled by the dominant director nor transactions with inadequate documentation.