Answers

1 (a) Risk appetite

Explanation

Risk appetite describes the willingness of an entity to become exposed to an unrealised loss (risk). It is usually understood to mean the position taken with regard to two notional preferences: risk aversion and risk seeking. Both preferences are associated with different levels of returns: those that are risk-seeking favour higher risks and higher returns with the converse being true for the risk averse.

Risk-averse entities will tend to be cautious about accepting risk, preferring to avoid risk, to share it or to reduce it. In exchange, they are willing to accept a lower level of return. Those with an appetite for risk will tend to accept and seek out risk, recognising risk to be associated with higher net returns.

Risk appetite and selection

The Jayland option has a higher political risk, a threat to the integrity of the company (by paying the bribe) and an element of reputation risk. There is also a risk arising from the lack of business culture in Jayland and a possibility that it will be more difficult to maintain normal operations there than in Pealand. Offset against these risks is the potential return of $2 billion over ten years, which is twice that of the Pealand option.

The Pealand option has negligible political risk but a slightly higher risk that internal controls will be difficult to implement. It has a much lower likelihood of reputation risk and there is no risk connected with bribery. The return is half that of the Jayland option (for an approximately equal investment value).

The two options offer two different risk and return profiles: the Jayland option offers a higher return but a higher risk profile and the Pealand option offers a lower return but also a lower risk profile. If the company has a higher risk appetite it is more likely to choose Jayland and if it has a lower risk appetite it is likely to select the Pealand option.

(b) AAA seven-step model

1. What are the facts of the case?

The facts of the case are that there are two investment options and each has a different ethical and risk profile although the AAA model is mainly concerned with the ethical aspects. The ability to operate the necessary internal controls for Hayho manufacturing also differs between the two options. Only one option can be pursued and both are capable of making an acceptable level of return.

2. What are the ethical issues?

The ethical issues are over the potential complicity of Hayho in supporting a corrupt regime in Jayland, in paying what appears to be a bribe to Mr Popo under the Jayland option and in operating under less stringent regulatory conditions in Jayland compared to Pealand. Another issue to consider is that it is alleged the president of Jayland maintains order by abusing the rights of the people. The company is very sensitive to allegations of human rights abuses after criticisms of Hayho were made in Arrland recently and it is reluctant to expose itself to similar criticisms again.

A further ethical issue is whether there is a corporate social obligation for companies to invest in developing or transitional economies to help stimulate these economies. However, these disadvantages have to be weighed against the likelihood of making twice the return for shareholders in Jayland against the option of operating sustainably in a more stable Pealand. In Pealand, there may be ethical issues concerning taking over an existing workforce and changing working terms and conditions, perhaps in terms of changed expectations, contractual issues and redundancies.

3. What are the norms and principles that apply?

The norms and principles that apply in this situation are that business investment decisions should be taken on a sound commercial basis with risk, return and ethical considerations fully taken into account.

The case says that the company seeks to 'always uphold the highest standards of integrity, human rights and environmental protection whilst at the same time 'responsibly' supporting developing countries by providing jobs and opportunities to enable greater social and economic development.'

This would tend to favour decisions that do not involve bribery (against integrity), human rights abuses (perhaps through supporting corrupt governments), but at the same time seeking, where possible, to use investments to support local economic development (perhaps by investing in developing countries, all other things being equal).

4. What are the alternatives?

The first alternative is to invest in Jayland, where a 'new-build' factory would enable Hayho to implant its culture and systems but where there is a poorly developed education system, a potentially unstable political environment and an absence of internal control and corporate governance regulations.

The other alternative is the Pealand option, to take over an existing plant and an inherited workforce in a more highly regulated business environment.

5. Which option is most consistent with norms and principles?

Both options have strengths and weaknesses, depending upon how the different factors are evaluated. The Jayland option would meet the criteria for financial acceptability and would be favourable through supporting economic growth and by providing net additional employment in a developing country.

The option most consistent with stated norms and principles is the Pealand option. This option has the benefit of inheriting a trained and competent workforce and avoids the reputation risk of providing credibility for the Popo regime and of being exposed, perhaps by a whilstleblower, for paying the 'royalty' (which is effectively a bribe to Mr Popo). The Jayland option would provide a greater financial return and provide net additional employment in a developing country. But it also would violate the principle of sound risk management because investing in an unstable and potentially hostile political environment could expose Hayho to unacceptable levels of long-term operational, financial and reputational risk.

6. **What are the consequences of each option?**
In Jayland, as opposed to Pealand, a completely new factory would be built providing new additional employment, although there could be an issue with sourcing the appropriate staff, given the poor levels of education and training. The Jayland option would provide a higher potential return to shareholders, but at a greater risk. It would make implementing the internal controls potentially easier but would risk reputation-damaging allegations of supporting Mr Popo's regime. Were the 'royalty' to be made public, it would have severe consequences for the trustworthiness of the Hayho board, having given the reassurances it did after the Arrland incident.

The Pealand option would make a smaller return and involve lower risk, but could introduce potential problems with implementing the necessary internal controls. This option would be more ethically acceptable. Hayho would be severely criticised for supporting a corrupt regime if it invested in Jayland. But if it invested in Pealand, no bribery would be necessary and it could publicise the fact that it chose to invest in Pealand over Jayland because it is seeking to honour its commitments made after the previous Arrland incident.

7. **What is the decision?**
The decision most aligned to the company's stated norms and principles is the Pealand option. Other powerful countervailing factors would also have an influence, however, as risk and internal control considerations would also be taken into account.

[**Tutorial note:** *reward answers arguing for Jayland if shown to be based on reasoning from step* 6]

(c) General purposes of internal control systems and main challenges.

General purposes
The first general purpose of internal control is to achieve the *orderly conduct of business by facilitating effective and efficient operation* of an organisation's activities. In doing this, it must be able to respond appropriately to relevant risks and to configure activities to be able to achieve the organisation's strategic objectives. This includes *safeguarding the assets* of the organisation from external and internal threats and to ensure that all actual and potential liabilities and sources of loss are identified and controlled. The protection of value is important in underpinning confidence in internal controls and in providing the capacity for future value adding.

Internal controls are essential in *ensuring the robustness, quality and timeliness of both internal and external financial reporting*. The provision of this information is important in managing internal systems (e.g. budgetary controls) and in maintaining and cultivating confidence among shareholders and capital markets. This involves maintaining accurate records and processes capable of generating and processing the relevant information.

Internal control is necessary to *ensure compliance* with any external laws, standards or regulations that apply. These could arise from companies' legislation, listing rules or, in some industries, regulations imposed by sector-specific regulators.

Main challenges
Jayland was *very under developed until relatively recently and the national culture is, according to Emily Baa, unfamiliar with modern business practice and behaviour. Achieving effective and efficient operation of the business* would be an early priority for the Hayho investment and this limitation would necessitate substantial initial training and cultural-familiarisation. If these cultural values (e.g. time-keeping, work commitment, honesty of workers, etc) cannot be taken for granted in a national culture then it represents a major obstacle in achieving normal plant operation.

Emily reported an *unknown security situation in the region with regard to the safeguarding of assets*. Being able to ensure that non-current assets owned by Hayho are secure and being used for the intended purpose is an essential element of internal control. The value of Hayho belongs to its shareholders and it would be irresponsible of the board (as agents) to invest in assets in Jayland unless reasonable assurances could be given that they will be safe from sabotage, damage, theft, deterioration or inefficient utilisation.

Emily's third point was about the level of *necessary skills in the local labour pool*. She mentioned the state of *quality control and accounting skills* and both of these are necessary for a sound system of internal control.

Appropriate quality control staff are necessary to ensure that the product *complies with the stringent international product standards* that apply to Hayho's products. Where technical skills such as these are difficult to obtain in local labour markets, unskilled people may need to undergo training, or expatriates may need to be persuaded to move to the Jayland facility. Guaranteeing that outputs from the Jayland plant were fully compliant with all applicable standards would be an important early priority for customers and investors and so this issue is likely to be of great importance.

Accounting skills are necessary for guaranteeing *accurate and complete accounting records and for reliable financial information*. Gathering required data and reporting to management at head office is required, for example on metrics such as variance against agreed targets. For a new investment such as those being considered by the Hayho board, the provision of accurate and timely information is essential in controlling activities under either of the options.

(d) (i) Meaning of accountability and Mendelow.

Briefing notes for board meeting.

Prepared for Helen Duomo, chief executive.
By Emily Baa
Wednesday 20 June, 2012.

Accountability of the Hayho board
The two letters received raise important issues of accountability, and specifically, the issue of to whom the board of Hayho is accountable. In reflecting on how to deal with this and how to frame our response, it may be helpful to consider the accountability situation we face as a board.

Accountability is a key relationship between two or more parties. It implies that one party is accountable to, or answerable to, another. This means that the accountable entity can reasonably be called upon to explain his, her or its actions and policies.

This means that the accountable party can be held to account and may be required to actually give an account. This has the potential to influence the behaviour of the accountable party, in this case Hayho, because of the knowledge that they will have to answer for it when they give that account.

Whilst it is clear that the board is accountable to the shareholders as stewards of their investment, it may be the case, nevertheless, that the board may need to account to WB because of its influence among politicians and in wider society, as outlined below.

Influence of Watching Business
The Mendelow framework is a way of mapping stakeholders with regard to the two variables of interest and power. The combination of these is a measure of any given stakeholder's likely influence over an entity such as Hayho. The framework is dynamic in that stakeholders move around the map as their power and interest rise and fall with events. WB has a moderate degree of power and a variable degree of interest. Because its interest (in Hayho) has recently increased, its overall influence has risen. Our response to WB must be responsive to this.

WB's power derives from its ability to conduct research and mobilise opinion, including among policymakers and trade organisations, against businesses like Hayho. We do not need to agree with its agenda to appreciate its power. Its power is expressed as influence when its interest is also increased.

It was news of our possible investment in Jayland that increased WB's interest in Hayho. This, combined with its evident power, increases its net influence over Hayho. This makes WB difficult to ignore in our decision over whether to invest in Jayland or Pealand.

(ii) Agency and demands from WB

Responsibilities to shareholders
The board of Hayho exists in an agency relationship with its shareholders, who collectively own the company and have the legal and moral right to determine objectives. As agents of our shareholders and appointed by them, we have a fiduciary duty to seek to manage the company's resources for their overall economic benefit. In the case of Hayho, as with most business organisations, this involves maximising returns consistent with our complying with relevant laws, regulations and norms. Quark Investments, as one of our major shareholders, has every right to remind us of this duty and we should take its reminder very seriously.

Lobby group demands
Whilst being well-meaning, the lobby group WB is against one of the investment options we have at this time. It claims that an investment in Jayland would be damaging to human rights in that country. Without commenting on the accuracy or validity of that claim, we should remind colleagues why we might think carefully about the investment, as it would bring us into conflict with WB.

First, WB is respected and its views are trusted by many people. In terms of reputation, it has highlighted our problems in Arrland and, as a result of that, has been monitoring our activities. We may need to consider public opinion before going ahead with a potential Jayland investment as we need the general support of society to operate.

Second, WB has influence among politicians and policymakers both in this country and abroad. We risk the censure of influential people and increase the pressure for increased regulation if we disregard or act against the lobby group's demands. Our reputation in international markets is one of our strategic assets and it may compromise our commitment, given the Arrland incident, if we were not to uphold the highest standards of integrity, human rights and environmental protection from now on.

Third, WB is very adept at mobilising public opinion through the media. This means that it can stimulate interest in conditions in Jayland and we would be likely to be heavily scrutinised on an ongoing basis were this investment to be made. This could attract public anger and risk disruptions, such as boycotts of our products.

Because of these issues, it would seem prudent to consider these issues as a part of our investment appraisal between the Jayland and Pealand options.

2 (a) Independence and NEDs.

Define independence

Independence is a quality possessed by individuals and refers to the avoidance of being unduly influenced by a vested interest. This freedom enables a more objective position to be taken on issues compared to those who consider vested interests or other loyalties.

Independence can be threatened by over-familiarity with the executive board, which is why many corporate governance codes have measures in place to prevent this. These include restrictions on share option schemes for NEDs, time-limited appointments and bans on cross-directorships. Other restrictions, depending on jurisdiction and code, include salaries being set at an appropriate level for NEDs, a compulsory number of years after retirement from a company before being eligible for a NED role (if ever), and no close personal relationships between executives and non-executives.

Benefits of greater independence

In the case of the independence of non-executive directors, Mr Louse is arguing that those with no previous contact with the other members of the board and who come from outside the industry that Zogs is in, will be more independent than those who may have some form of vested interest. In this he is only partly accurate: whilst succession to a NED role from an executive position in the same company is likely to threaten independence, appointments to NED positions from other companies within the same sector are quite common and still provide industry knowledge to a board.

The first benefit of greater independence is that independent people brought in as NEDs are *less likely to have prior vested interests* in terms of material business relationships that might influence judgments or opinions. Such vested interests may involve friendships with other board members or past professional relationships. Past or current equity holdings in companies within the industry may encourage unhelpful loyalties (many CG codes restrict NEDs from holding shares or share options in companies they are on the boards of).

Second, they are *likely to have fewer prejudices* for or against certain policies or individuals as working relationships will not have been built up over a number of years. Accordingly, they are likely to start from the 'ground up' in seeking clarifications and explanations for each area of discussion. Previous rivalries, alliances or embedded ideas would not frustrate discussions and this may allow for more objective discussions.

Third, independent non-executive directors are more likely to *challenge the established beliefs of less independent people* (such as executive directors). This is a more effective way of scrutinising the work of board committees and of increasing their effectiveness. This has the advantage of challenging orthodoxy and bringing fresh perspectives to committee discussions.

Disadvantages of greater independence

Some NEDs are appointed because of their connections with the existing board, either through prior industry involvement, prior executive membership or prior service on another board with one or more other directors. These are considered by Mr Louse to be less independent.

There are, however, a number of advantages when NEDs have some familiarity with a company and board they are joining. A key non-executive role, including in board committees, is providing strategic advice. This can often arise from a *thorough knowledge of the strategic issues in a company or industry*. Retired executive directors, like Mr Louse, sometimes serve as NEDs in the same company and are thus able to bring their experience of that industry and company to bear on committee discussions (although in some countries, there are time restrictions on executives becoming NEDs in the same company).

Some level of prior connection is advantageous when *some level of technical knowledge is required*. Therefore, Mr Louse's comments about independence depending upon NEDs' needing to be from a different industry background or sector is not quite appropriate. When serving on an appointments committee, for example, knowledge of the industry and the technical aspects of a company's operations will increase effectiveness. This might apply in electronics, chemicals, accounting services and financial services, for example. When serving on a risk committee in, for example, a bank, a technical knowledge of key risks specific to that particular industry can be very important.

The *contacts and personal networks* that a NED with industry experience can bring may be of advantage, especially for informal discussions when serving on a nominations committee, for example.

(b) Risk committee and criticise Mr Louse's understanding.

Roles

There are five general roles of a risk committee. The first is *agreeing and approving the organisation's risk management strategy*, including strategies for strategic risks. This is likely to be drawn up in discussion with other parts of the organisation, including the main board.

Second, the risk committee *reviews reports on key risks* prepared by departments on operational risks. These might be reports from operations (e.g. production), finance or technical departments on risks that specifically may affect them.

Third, it *monitors overall risk exposure* and ensures it remains within the limits established by the main board. Exposure is generally defined as the totality of losses that could occur and the acceptable exposure will vary according to the risk strategy. Some organisations accept a higher exposure than others because of their varying risk appetites.

Fourth, the risk committee *assesses the effectiveness of risk management systems and policies*. This is usually based on past data, where a risk has materialised, or 'stress testing' of systems where the risk has not yet materialised.

Fifth, the risk committee *approves and agrees any statements or disclosures* made to internal or external audiences, such as risk reporting to analysts or in the annual report. Shareholders have the right to expect accurate and relevant reports on the risks in their investments, and so any reports issued outside the company need to be approved by the risk committee.

Criticise Mr Louse's understanding

Mr Louse has a weak understanding of the roles and purposes of a risk committee.

First, *'stopping risks affecting' companies is not within the remit of a risk committee.* Some risks affect everybody including businesses; others apply because of industry membership, geographical location, business activity, strategic positioning or business strategy. The role of a risk committee is to identify, review and construct a strategy for managing those risks.

Second, he complained that the risk committee was 'always asking for more information, which was inconvenient'. *Gathering information is a crucial part* of a risk committee's role and it is in the company's overall interest to ensure that information supplied to the risk committee is accurate, current and complete.

Third, *he misunderstands the nature of the committee's role if he perceives it to be 'gloomy and pessimistic'.* This is an understandable but unfair criticism. Risks are, by their nature, things that might go wrong or potential liabilities, but the reason why risks need to be understood is to ensure the ongoing success and prosperity of Zogs Company, and that is a very positive thing.

Finally, he *wrongly believed that all material risks were external* risks and so the risk committee should be looking outwards and not inwards. Risks can be internal or external to the company and many internal risks can be highly material such as financial risks, liquidity risks, operational risks, etc.

(c) Risk monitoring more important in larger companies than in smaller companies?

Small companies exist in different strategic environments to large companies and because of this, a number of differences apply when it comes to corporate governance systems. There are a number of compliance issues, for example, where large companies are required to comply with provisions that smaller companies are not. Some of the differences in regulation and shareholder expectations are driven by differences in the legal status of the organisation (e.g. whether incorporated, whether listed, where domiciled, etc).

In the case of risk management systems in smaller companies, there will be a *lower overall (aggregate) loss to shareholders* than in a large company in the event of a major risk being realised. In larger companies, especially listed companies, a major event can affect markets around the world and this can affect the value of many funds including pension funds, etc. This is unlikely to be the case in any given smaller company.

Many smaller companies, including SmallCo, are privately owned and they are therefore *not subject to listing rules and, in some cases, other legal regulations*. In many smaller companies, any loss of value when a risk is realised is a personal loss to owners and does not affect a high number of relatively 'disconnected' shareholders as would be the case in a large public company.

Risk probability and impact is often correlated with size. Smaller companies have fewer risks because of their lower profiles, fewer stakeholders and less complex systems than larger organisations. Accordingly, the elaborate risk management systems are less necessary in smaller companies and could be a disproportionate use of funds. This is not to say that smaller companies do not face risks, of course, but that the impacts, say to shareholders or society, are less with a smaller rather than a larger company because of the totality of the losses incurred.

The costs of *risk monitoring and control may often outweigh the impacts of losses* being incurred from risks, if not in a single financial period then maybe over a period of years. There are substantial set-up fixed costs in establishing some risk management systems and, in some cases, variable costs also (e.g. linked to production output). With fewer total risks, there could be less value for money in having risk controls.

In summary, risk committees and risk mitigation systems are more important in larger companies than in smaller companies. However it is good practice for all companies, however small, to carry out some form of risk monitoring in order to remain competitive in their environment.

3 (a) Conflict of interest and discuss the consequences.

Conflict of interest

A conflict of interest occurs when a person's freedom of choice or action is constrained by a countervailing interest, which means that the most objectively correct course of action cannot be taken. The discretion to act correctly is fettered by the need to protect a related but contradictory interest. In the case of Jojo Auditors, Jack Hu experienced a conflict of interest between carrying out the agreed policy of dismissing all students assessed as 'poor' (such as Polly Shah) and his familiarity with the Shah family and his making a personal gain from the family in the form of free holidays.

Consequences

Mr Hu *acted against the best interests of the firm* including his fellow partners. In his role as managing partner, he owes it to the other partners, and to the employees and clients of the firm, to act responsibly and always in the best interests of the firm. His conflict of interest prevented this from happening.

In acting as he did, Mr Hu *compromised the other committee members and made them compromise their own professional values*. Both the training manager and the representative from human resources are engaged in order to maximise their benefit to Jojo and as managing partner, Mr Hu 'bullied' them into accepting his view. This decision undermined the training manager and thus circumvented the normal chain of command in matters of student assessment.

He knowingly allowed a technically weak student to be retained thereby potentially *compromising the quality and integrity of the audits* she would work on. He owes a professional duty to the shareholders of the companies that Jojo audits. Audits should be conducted diligently, and technical accuracy should underpin the application of auditing standards and in following procedures and protocols. A technical weakness (such as Polly's) would potentially weaken the effectiveness of the audit and hence be a failure of a duty of care to the client's shareholders.

In acting as he did, Mr Hu *gave the appearance of unfairness and a lack of objectivity*. The appearance of integrity and probity is important in leading organisations and even were it not true, Mr Hu allowed his integrity and objectivity to be seen as questionable. Once discovered to have made the decision he did, confidence in the assessment process at Jojo would have been lost and this could have the effect of damaging its reputation as a provider of training contracts, and therefore in the services provided by the firm.

(b) **Ethical safeguards.**

Mr Hu could *undergo some instruction or continuous professional development (CPD)* on the fundamental principles of professionalism and the need to avoid conflicts of interest. As a professional accountant, he is bound in any case by the codes of ethics and/or rulebook of his professional body and the IFAC code. Most of these specifically warn against such conflicts, including the acceptance of gifts unless the value is trivial and inconsequential, and his professional body may provide such a course of instruction.

Enforce a requirement to *declare any conflicts of interest* at the beginning of each meeting to consider student assessments. This could be made a 'standing item' on the agenda so that it had to be considered before each time that assessments were considered. The declaration of conflicts of interests could also be made a part of the recruitment process for new partners where appropriate.

Rotate the partner who chairs the assessment committee. This would mean that the chance of Mr Hu being the partner considering Polly Shah's case would be reduced (in the case of Jojo) to one in five. Other partners without the conflict of interest would, in any given meeting, be more likely to be chairing.

Involve an additional partner in the review of student assessments, more able to confront Mr Hu than the training manager or HR manager, neither of whom are at partner level. Another partner would have the organisational 'weight' to confront Mr Hu in a way that the training manager or HR manager evidently did not.

The outcomes of the assessments could be *validated by an external party* (akin to the role that a non-executive director might play if Jojo were a public company). A retired partner could discharge such a role, for example, or a human resources consultant. The final decision on each student would not be made known until each had been 'signed off' by the external party.

Keep an internal HR file *formally recording the list of students by assessment category*. This would make the decision to retain Polly, in spite of her 'poor' assessment, much more visible to relevant business managers. This would apply greater consistency because it would be more transparent that Polly was retained even though her assessment was rated as 'poor'.

[**Tutorial note:** *allow any reasonable safeguard that addresses the problem.*]

(c) **Performance evaluation of partners.**

Criteria for individual performance measurement
The criteria used to measure the performance of directors and/or partners (in a partnership) vary according to the situation. Some criteria will be much more important than others, and highly context-specific criteria may apply in some organisations. In general terms, however, four typical criteria are helpful to consider.

The level of independence of the person (such as being free from external vested interests) and commitment to the public interest. This is especially important in accounting practices where serving the public interest is an important component of professional service.

Preparedness and fitness to practise including maintaining the relevance of skills and undertaking relevant continuing professional development. For the partners and Jojo, this would involve maintaining knowledge of current audit and reporting standards, for example.

Practice, including levels of participation in their allocated roles and their competence in those roles. Linked to this is the contribution made to the formulation and implementation of the organisational strategy.

Contribution to committee work and administrative duties as appropriate. Mr Hu's effectiveness in his role as member of the committee that evaluates student progress would fall within this area, for example.

[**Tutorial note:** *allow other relevant criteria if appropriate.*]

Difficulties of individual performance measurement at Jojo
As a privately-owned business, there is no external pressure for such a procedure. This is because, as an unincorporated business, there are no listing rules enforced by a stock exchange and no external shareholder pressures to be applied. There is no agency gap created by a separation of ownership and management.

There is unlikely to be an independent non-executive director (NED) structure in place to support and carry out the performance measurement. Because of the difficulties raised by full-time senior management appraising each other, NEDs take a role in this in listed companies. Without this element of external independent scrutiny, it would be very difficult to maintain independence and fairness in a performance measurement system.

The informality of relationships in a smaller partnership may make objective assessment impossible, especially if, as in a smaller practice, longstanding personal friendships may be a strong component of the culture. With the five partners being personal friends with each other, it would be very difficult for the partners to conduct objective performance appraisals on each other.

There is likely to be resistance from some partners, at least from Jack Hu, who, if appraised, would be likely to receive a poor assessment on some criteria. As the managing partner (the equivalent of a chief executive in a partnership), it would be difficult to arrive at a fair measurement process for Mr Hu without the involvement of external parties (such as NEDs).

4 (a) Family business and a listed company.

Compare family and listed

There are a number of differences between the governance arrangements for a privately-owned family business like Lum Co and a public company which Lum Co became after its flotation.

In general, governance arrangements are much *more formal* for public companies than for family businesses. This is because of the need to be accountable to external shareholders who have no direct involvement in the business. In a family business that is privately owned, shareholders are likely to be members of the extended family and there is usually less need for formal external accountability because there is less of an agency issue.

Linked to this, it is generally the case that larger companies, and public companies in particular, are *more highly regulated* and have many more stakeholders to manage than privately-owned, smaller or family businesses. The higher public visibility that these businesses have makes them more concerned with maintaining public confidence in their governance and to seek to reassure their shareholders. They use a number of ways of doing this.

For example, public companies must comply with regulations that apply to their stockmarket listing (*listing rules*). Whilst not a legal constraint in a principles-based jurisdiction, listing rules require listed companies to meet certain standard of behaviour and to meet specific conditions. These sometimes include using a unitary board structure and thus, in the case, would require a change in the governance arrangements at Lum Co.

The more formal governance structures that apply to public companies include the requirement to *establish a committee structure* and other measures to ensure transparency and a stronger accountability to the shareholders. Such measures include additional reporting requirements that do not apply to family firms.

Assess Crispin's view

It is likely that the flotation will bring about a change in the management culture and style in Lum Co. Flotations often cause the loss of the family or entrepreneurial culture and this contains both favourable and unfavourable aspects. Whether the company loses the freedom to manage as they wish will depend upon a number of factors.

Firstly, *whether Gustav Lum's 'wishes' (such as the values and beliefs) are known and trusted by the shareholders*. The need for returns to meet shareholder expectations each year often places cost pressures on boards and this, in turn, sometimes challenges a paternalistic management style (such as at Lum Co) which some investors see as self-indulgent and costly.

Second, the company will become *subject to listing rules* such as the governance code, and, because of its higher visibility on the stock market, a range of *other societal expectations* may be placed upon the company. This will have an effect on all aspects of the company's internal systems and norms, including its prior management style. Because of these things, the family will no longer be able to choose how to act in a number of ways, which supports Crispin's view.

Third, the board of Lum Co will be subject to *influence from institutional investors*. They will demand an effective investor relations department, information on a number of issues throughout the year, briefings on final year and interim results and sound explanations whenever performance or behaviour is below expectation. This places the management of Lum Co in a very different environment to when it was privately owned.

Fourth, the board will be under pressure to produce *profits against targets* each year, which may militate against the company's previous long-term and sustainable commercial approach. If, for example, the long-term approach may have meant taking less profit from a particular operation in one year to leave liquidity or cash in place for a future period, this may become more difficult for a listed company, which can sometimes be under pressure to achieve short-term financial targets such as a dividend payment.

(b) Induction and CPD

Induction for the new NEDs

Induction is a process of orientation and familiarisation that new members of an organisation undergo upon joining. It is designed to make the experience as smooth as possible and to avoid culture or personality clashes, unexpected surprises or other misunderstandings. In the case of the problems with NEDs at Lum, an effective induction programme will enable the new NEDs to gain *familiarisation with the norms and culture* of Lum. This might be more important for Lum, being at flotation stage and having a deep-seated family culture.

They will be able to gain an understanding of the *nature of the company and its business model*. This will, as with the culture and norms, be especially relevant for a company like Lum emerging from a long period as a private company with little need to explain its business model to outside parties.

Induction will help NEDs in *building a link with people* in Lum Co and other directors. The building of good quality interpersonal links is important in NEDs working effectively. This applies to their relationships with other executive and non-executive directors, and also with relevant people in the company itself. This is especially important in NEDs populating the board committees.

Induction will enable the new NEDs to gain an *understanding of key stakeholders* and relationships including those with auditors, regulators, key competitors and suppliers. In order to understand the business model operated by Lum Co, NEDs need to understand its external relationships and how these support the company's operation.

CPD for the existing executives

The purpose of any programme of CPD is to *update skills and knowledge* as relevant to the professional situation. This will typically involve content on regulation and law, best practice, new developments, etc. Directors should undergo CPD regularly to keep these areas up to date and to ensure they do not 'fall behind' on key skills.

In the case of the changes at Lum Co, another specific benefit of CPD will be *learning about working with NEDs and the new board procedures* that apply to listed companies. For Lum Co this involved creating a new unitary board, employing NEDs and generally taking a more consultative approach to decision-making.

They would also benefit from *learning about compliance requirements* as a listed company. Legal and regulatory frameworks differ between private and public companies. The listing rules that will be imposed by the stock exchange may be seen as an imposition, especially the need to comply with the corporate governance code. This is likely to necessitate a lot of internal change in governance and reporting behaviour and the CPD will help to provide the directors with this support.

After the flotation, the board of Lum Co gained a number of shareholders other than the Lum family. This would have created a new governance environment and so *learning about coping with the expectations of shareholders* would also be a benefit of the CPD. This would include, for example, learning about investor relations, dealing with shareholders at an AGM and similar.

(c) Unitary and two-tier boards.

Distinguish between

In a unitary board, all directors, including all executive and non-executive directors, are members. All directors are of equal 'rank' in terms of their ability to influence strategy and they also all share the collective responsibility in terms of legal and regulatory liability. There is no distinction in constitution or law between strategic oversight and operational management.

In a two-tier board, responsibilities are split between a supervisory or oversight board (chaired by the company chairman), and an operational board (usually chaired by the chief executive). The supervisory board decides on strategic issues and the operational board becomes responsible for executing the strategy determined by the supervisory board. Responsibilities between the boards are clearly demarcated with the supervisory board responsible for many legal and regulatory compliance issues (such as financial reporting). Directors on the lower tier (operational board) do not have the same levels of responsibility or power as those on the supervisory board.

Difficulties for the Lum family

The first difficulty for the Lum family is the *loss of the tight control* they enjoyed prior to the flotation. In a unitary board, all strategic decisions need to be taken by a full board including the NEDs. It is precisely to prevent small groups of powerful executives from making decisions on their own that the counterweight of the non-executive board was introduced. This may lead to frustration in the Lum family members, which may affect the objectivity of some decisions.

The company will *lose the capacity for fast decision-making* in the family supervisory board because of the need to involve everybody. Large boards generally meet regularly but on fixed dates. NEDs and other executive directors are likely to seek explanations for decisions taken outside the main board discussions and can act against any members, including family members as the Lum family only controls 20% of the shares.

The *change in culture* brought about by the governance changes are difficult for the family to manage and the movement to a unitary board is likely to add to the difficulty of this adjustment. The need to consult widely (on a larger board) and to seek consensus are likely to be significant changes for the Lum family. For those used to the family way of managing the company, these changes are likely to be difficult to deal with.

[**Tutorial note:** *allow latitude on the 'difficulties' part of this answer.*]

1 **(a)** 3 marks for explanation of risk appetite. 1 mark for definition, 1 mark for evidence of understanding of each preference. 1 mark for correct direction and 1 mark for explanation of each to a maximum of 3 marks each.
(Maximum 6 marks)

(b) 1 mark for each relevant point, in the appropriate section. Half a mark for identification only.
(14 marks)

(c) 1 mark for each purpose of IC to a maximum of 4 marks. Half a mark for identification only to a maximum of 2 marks. 2 marks for each challenge identified and assessed to a maximum of 8 marks.
(12 marks)

(d) **(i)** 1 mark for each relevant point on accountability to a maximum of 3 marks.
2 marks for evidence of understanding of Mendelow framework
2 marks for discussion of WB's power, interest and influence.
(7 marks)

(ii) 1 mark for each relevant point on agency to a maximum of 2 marks.
2 marks for each argument on WB's demands to a maximum of 6 marks.
(Maximum 7 marks)

Professional marks for clarity, flow, persuasiveness and structure.
(4 marks)

2 **(a)** 2 marks for definition of independence.
1 mark for each argument for or against (allow cross marking) to a maximum of 6 marks.
(8 marks)

(b) 1 mark for each role described to a maximum of 5 marks.
1 mark for each point of criticism to a maximum of 4 marks.
(9 marks)

(c) 2 marks for each explanation of Mr Louse's belief.
(8 marks)

3 **(a)** 2 marks for definition of conflict of interest.
2 marks for each consequence discussed to a maximum of 8 marks. Half a mark for identification only.
(10 marks)

(b) 2 marks for each relevant safeguard identified and described.
(8 marks)

(c) 1 mark for each relevant point on typical criteria to a maximum of 4 marks.
1 mark for each relevant point on implementation difficulty to a maximum of 4 marks.
(Maximum 7 marks)

4 **(a)** 4 marks for contrasting family and listed.
2 marks for each relevant point of assessment to a maximum of 6 marks.
(10 marks)

(b) 1 mark for each contribution of induction to a maximum of 4 marks.
1 mark for each contribution of CPD to a maximum of 4 marks.
(8 marks)

(c) 4 marks for distinguishing between (2 marks for each).
1 mark for each difficulty discussed.
(7 marks)