Institute of Chartered Secretaries and Administrators

Canadian Division
Corporate Governance

Sample Paper – Suggested Answers

Important notice

When reading these answers, please note that they are not intended to be viewed as a definitive ‘model’ answer, as in many instances there are several possible answers/approaches to a question. These answers indicate a range of appropriate content that could have been provided in answer to the questions. They may be a different length or format to the answers expected from candidates in the examination.

General note
The questions in the examination paper include a scenario or small case study. In the marking of examination scripts, credit is given to candidates for referring to these scenarios in their answers in order to make or illustrate relevant points.

Questions

*Answer **four** questions from this paper.*

1. Ambio is a TSX listed company. It recently made a takeover bid for a large foreign company, as part of a strategy of the board of directors to grow the business globally. The decision to make the bid was taken after a series of board meetings on company strategy, and the board recognised that there was a significant business risk in extending the company's foreign operations. To finance the purchase cost of the takeover, the company announced that it would have to make a large rights issue of new shares. Several major shareholders objected to the bid, on the grounds that the offer price was too high. Some shareholders had meetings with the company chairman to discuss their views, which the chairman passed on to the full board of directors. Eventually, the board gave way to shareholder pressure and agreed to reduce the offer price for the takeover. However, the board of directors of the takeover target rejected the lower offer, and the takeover negotiations came to an end with failure to agree terms.

   Ambio will incur very large costs in connection with the failed bid, mainly from fees and expenses payable to investment banks, firms of lawyers, accountants and other advisers. The total amount of costs written off will be equal to the company's total equity dividend payments to shareholders in the previous financial year. Many shareholders have expressed their anger about these costs, and have blamed the company chief executive officer (CEO) for proposing the ill-advised takeover bid and the company chairman for failing to lead the board in a challenge to the CEO's proposal.

   Required

   (a) Discuss, with reasons, whether the board of directors of Ambio has failed to comply with expected standards of best practice in corporate governance, in deciding to make the takeover bid and then to revise the offer in response to shareholder pressure.
   (8 marks)

   (b) Describe how institutional investors with shares in Ambio should follow best practice in stewardship in their dealings with the board of directors of the company.
   (8 marks)

   (c) Suggest what measures might now be taken by shareholders who remain angry and dissatisfied with the chairman and the CEO of Ambio, and believe that they have provided inadequate leadership for the company.
   (9 marks)

   (Total: 25 marks)

<u>SUGGESTED ANSWER</u>

(a) In the comments that follow, standards of best practice in corporate governance are assumed to relate to the principles and provisions *outlined in Dey: "Where were the directors" and in NP 58-201*.

The situation described in the question is likely to be a rare event, although it is not unprecedented. Such an unusual event can test the resilience of a company's corporate governance practices.

The board appears to have complied in some ways with best practice in corporate governance in the following ways.

(i) The Ambio board recognised that there would be significant business risk in the strategy to expand globally. The amount of risk in the strategy would be much higher if economic conditions were volatile, than if economic conditions were stable in the markets of the target company. Without further information, it is therefore not clear whether the board has satisfied itself that the risk management system within the enlarged company (after the takeover) would have been sufficiently sound and robust. Failure to consider business risk adequately would be a weakness in corporate governance practice.

(ii) A principle of the TSX Guidelines s. 474 and NP 58-201 *is* that the board has a responsibility to ensure that a satisfactory dialogue with shareholders takes place. Although contact with shareholders will usually be through the chairman, CEO or finance director, the chairman should ensure that all the directors should be made aware of the concerns of shareholders. Ambio's chairman appears to have done this, meeting with shareholders and reporting their concerns to the rest of the board.

(iii) A provision of the *NP 58-201* is that the Board should discuss strategy with major shareholders. In the matter of the proposed takeover bid, Ambio's Board through the chairman appears to have done so.

(iv) *Saucier* suggests that Independent Directors should be offered the opportunity to attend scheduled meetings with shareholders, and should attend meetings if shareholders ask for them to do so. In any case, it would seem that Ambio's chairman did meet with some shareholders at their request and did pass their concerns onto the Board. But the attendance of Independent Directors (or the lead independent director) was not considered to have been necessary. However, it could be argued that other directors should have attended meetings with shareholders, to make sure that the views of those shareholders were fully understood.

(v) Neither Dey-nor any other Canadian report or regulation suggests that the board should give way to shareholder pressure on all matters, but in this case the board listened to the views of shareholders and reduced the size of the takeover bid. It could therefore be argued that the board engages with its shareholders and responds positively to their concerns.

However, it could also be argued that in an important respect the board did not engage in dialogue sufficiently with its shareholders. The takeover bid was made by the board, and in view of the adverse shareholder reaction, it might be supposed that the board failed to discuss its strategy and intentions with shareholders before the bid took place. There are difficulties with discussing price-sensitive matters with shareholders before a public announcement is made. Even so, the board might have been better aware of shareholder opinion beforehand, and that the board was not 'in touch' with its shareholders as much as it could have been.

(b) It is important to recognise that the shareholders should not get involved in the detailed management of their company. Shareholders appoint the board of directors to run the company in their interests. They can discuss their concerns with the board, and try to influence board decisions, but it is for the board to decide what is in the best interests of the company.

Canadian institutional investors with shares in Ambio might be expected to comply with the principles of good stewardship outlined in Dey and implied in Kirby. These principles include a requirement that institutional investors should monitor the companies in which they invest, in order to decide when it might be necessary to enter into active dialogue with the company's directors. Monitoring will include meetings with directors, and records should be kept of what was discussed at these meetings. Investors should also keep an audit trail of votes against the company's board, or abstentions from voting. They should also attend general meetings of the company where appropriate and practicable. They should try to identify any problems at an early stage and if they have concerns, they should raise them with an appropriate member of the board of directors.

Institutional investors should be careful about the risk of receiving information from a company that makes them insiders, and unable to deal in the shares of the company (without breaking the law). The nature of discussions with directors should therefore have regard to this risk, and is one reason why records should be kept of any private meeting with members of the board of an investee company.

During the takeover negotiations, shareholders should have tried to avoid receiving inside information, for example, because as insiders they would not be able to sell (or buy) shares in Ambio when they might otherwise wish to do so.

Institutional investors should also establish clear guidelines on when and how they will escalate their activities, and enter into active dialogue with the board of a company (initially on a confidential basis). Concerns may relate to strategy or performance issues, or social and environmental risks.

Institutional investors should, where appropriate, be willing to act collectively and engage together with a company's board.

In response to the takeover bid by the board, institutional shareholders in the company would need to consider carefully how they should present their views or act collectively, for example by demanding changes in Ambio's board.

The shareholders should also have a clear policy on voting at general meetings and should make disclosure of their voting activity. They should seek to vote all the shares they hold.

(c) Shareholders who remain dissatisfied with the actions of the board of Ambio, and the high costs that have been written off, should continue to make their views known to members of the board through active dialogue. Initially this may take the form of confidential meetings, although some investors may choose to encourage the reporting of their dissatisfaction in the financial press and other media.

In their discussions with the company chairman, shareholders may raise the subject of the board's effectiveness, possibly in the context of the published guidance from the TSX-s 474 on board effectiveness. They may remind the chairman that they expect him to report personally in the company's annual statements about board leadership and effectiveness. The Saucier Report includes the suggestion that there must be good communication between the board and the shareholders and that all directors should be made aware of the views of major investors in the company.

Various institutional investors may discuss the matter between themselves, with a view to collaborating on an initiative. Such an initiative might involve meetings with the chairman or the CEO, and recommendations that they should resign. Alternatively, there may be dissatisfaction with the independent directors of the company, and their failure to take a stand against the takeover bid. A meeting with the senior independent director may be arranged, to voice opinions about the need to remove the chairman or CEO, or to change the Independent Directors and 'shake up' the board.

The CBCA s106(3) include a provision that the directors of TSX listed companies should stand for re-election at least every 3 years. In some listed companies, where no term is listed, directors will cease to hold office after the next annual meeting. If some of Ambio's shareholders wish to do so, they can try to gather support for a vote against the re-election of one or more directors at the next AGM. However, any public move against members of the board will be made with caution, because shareholders will not wish to engage in action that might reduce the market value of their shares.

In addition to discussing possible changes to the board, shareholders will probably also make their views known about the company's dividend policy, and the effect of the failed bid on the current year's dividends.

Shareholders who remain dissatisfied have the option to reduce their shareholding in the company ('go under weight' with shares of Ambio in their investment portfolio) or possibly sell their entire shareholding.

2. Setton Services ('Setton') is a small private Canadian company, which was established five years ago by Les Setton ('Les'), an individual with great personal energy and entrepreneurial skills. He and members of his family own 100% of the shares in the company, which became profitable three years ago and continues to grow successfully. Les manages the company and is also the chairman of the board of directors, which consists of himself and three executive directors. He has a strong personality and dominates decision-making by the board.

Les thinks that he will continue to run the business for about three more years, and then hopes to sell it or to take the company on to one of the smaller stock markets in Canada. He can foresee that his young management team might want to buy the company from him, or that he might receive a takeover bid from a larger company.

Donald Mack ('Donald') is a good friend of Les, and has experience as a company secretary. He suggested to Les that if he plans to sell the company or to turn it into a public company in the next few years, he should consider making improvements in corporate governance. Les replied that he was not sure what corporate governance was, but that he thought the company was well-managed and successful, and so did not need any changes. He certainly believed that the board and the company's management had to remain entrepreneurial and that corporate governance measures would inevitably mean more administration and bureaucracy. Donald said that he understood Les's concerns, but that improvements in corporate governance could benefit the company and assist Les with his future plans.

Les also commented that he was considering a new incentive scheme, in which he would award new shares in the company to his executive directors and senior managers on condition that certain financial performance targets were met in two years' time. He considered that such a scheme would help to motivate his senior managers and align their interests with his own objective of selling the company in the not-too-distant future.

Required

(a) Explain the difference between governance of a company and management. State your views, with reasons, about whether governance imposes bureaucracy on a company and stifles entrepreneurship.

(8 marks)

(b) Excluding changes in remuneration policy, suggest changes that might be made to corporate governance practice in Setton, and explain how these would benefit the company or help Les with his future plans.

(10 marks)

(c) Discuss the possible implications of the proposed policy of rewarding senior executives with grants of shares in the company.

(7 marks)

(Total: 25 marks)

SUGGESTED ANSWER

(a) The Cadbury Report (1992) defined corporate governance as the system by which companies are directed and controlled. Corporate governance is therefore concerned with how a company is led and controlled, in the interests of shareholders and other stakeholders.

Management of a company refers to the executive tasks of planning, co-ordinating and controlling its business activities. Management applies to operational activities and also to the implementation of strategies that have been decided or approved by the board of directors. Managers are given delegated authority to carry out their responsibilities, and a generally led by and are accountable to the chief executive officer or a managing director. Management operates within a framework of governance provided by the board of directors.

Corporate governance refers to the leadership provided by the board of directors on behalf of the owners of the company (the shareholders), and also other major stakeholders. In terms of agency theory, the board of directors act as agents of the shareholders and are accountable to the shareholders for the way in which they use the responsibilities and powers given to them.

Governance matters include setting the overall business strategies for the company, with due regard to risk as well as return, and accountability to shareholders. A well-governed company is one that seeks to achieve the objectives of shareholders and other stakeholders, and to provide full and transparent disclosure about how this is being done.

Compliance with corporate governance principles and provisions has been criticised as a box-ticking exercise that creates no value and is bureaucratic in nature. In practice, this might be how corporate governance measures are applied in some companies. However, the aim of best practice in corporate governance is for the board of directors to provide entrepreneurial leadership for a company. Sensibly applied, corporate governance measures should enhance rather than restrict company leadership.

A company secretary, through his or her knowledge of corporate governance issues, company administration and how the board and its committees operate, should be able to contribute to effective corporate governance, so that the board remains entrepreneurial in its outlook and corporate governance compliance does not become a bureaucratic exercise.

(b) Note: A challenge for candidates answering this question is to identify aspects of corporate governance that could benefit a private company whose owner has plans to sell the company or turn it into a public company and launch it on to a stock market in the fairly near future. Candidates should not discuss a range of corporate governance issues that might not be appropriate for a private company.

Suggested solution
Changes in governance and management at Setton might not be needed as long as Les Setton and his family intend to own the company. However, if he plans in the foreseeable future to sell some or all of his shares in the company, he should be advised to improve some aspects of corporate governance. The purpose of such improvements should be to provide evidence for a potential buyer that the company is well-governed, and give the potential buyer some reassurance about the value of the company as an investment.

The following changes might be beneficial:

(i) The board could introduce one or more non-executive directors to the board. As Setton is a private company, these individuals need not be independent, and might be individuals that Les Setton already knows and trusts. Any Independent Director should bring useful skills and experience to the board. In the case of Setton, there may be value in appointing an individual with experience of taking companies on to a minor stock market in Canada, or with experience in the practicalities of selling companies.

(ii) Les Setton might consider the appointment of a finance director to the board. This individual might also have had some experience with listing or bringing a company to a stock market. Private companies often lack sufficient financial expertise to satisfy the requirements of stock market investors. The appointment of such an individual would therefore help to prepare the company for a conversion to public company status and its application for acceptance to a stock market.

(iii) Also with a view to selling the company eventually, Les should consider developing the reporting systems within the company, particularly reporting by management to shareholders.

(iv) A change in the external auditors to a larger and more experienced audit firm may be appropriate, to provide greater confidence in the reliability of audited financial statements.

(v) Les appears to be a dominant individual on the board of directors. He should consider the benefits of encouraging more balance on the board, partly by introducing Independent Directors but also by encouraging other executive directors to contribute more effectively. A potential buyer may see value in the fact that the company appears to have a well-balanced and experienced board in the company.

(vi) If the executive directors are hoping to continue with the company after its sale or stock market launch, it might be appropriate to arrange training for them, particularly in matters relating to corporate governance.

(vii) Les Setton may not wish to spend much of his time on corporate governance matters. If it is decided that improvements in corporate governance might make it easier to sell the company (for a good price) at some time in the future, he might appoint an individual with company secretarial and administrative responsibilities, including the task of providing advice on corporate governance and helping to introduce any changes in practice.

(c) Granting shares to senior executives would be of some potential benefit if they succeeded in providing an incentive to the individuals concerned and also helped to align the interests of those managers with the interests of the company's shareholders, who are currently Les Setton and his family.

The individual managers would only be incentivised if they could see sufficient value in the grant of shares. This may be the case if Les Setton has announced his intention to sell the company or to take it on to a stock market, because this would give the managers shares that they could sell or that should be marketable and have value. If Les Setton changes his mind and does not sell the company, the only value in the shares would be the dividends they might earn. The grant of shares is therefore likely to motivate the managers affected to create a more valuable company that can be sold.

Les Setton should also consider the implications of his proposed policy for existing shareholders and shareholder relations.

Other shareholders (family members) may not like the idea of giving away shares, because this would dilute their share of the value of the company. Shareholder approval would also be needed for a scheme involving the creation and issue of new shares. If new shareholders are eventually created, Les would also need to consider the implications of having non-family members as shareholders. The new shareholders might expect greater openness and transparency from the company.

The intention appears to be that new shares will be issued in two years' time, before the potential sale of the company after three years. It might be questioned whether an incentive scheme will have sufficient time to make any impact on the company's value within two years. A three-year period before the shares are granted might be more appropriate.

3. Sara King ('Sara') has just been appointed as independent director (ID), consistent with NI 58-101 Disclosure on Corporate Governance Practices of a medium-sized listed company. She has been asked to act as a member of the three-member audit committee, which has oversight and responsibility for review of the company's risk management system. At an introductory meeting with the chairman of the audit committee, Sara is told about some of the business risk issues facing the company at the moment:

(i) The company operates in a highly competitive industry, in which there are rapid technological developments. The global and national economies have been through a period of recession, but a period of sustained economic growth may now be under way. The company's CEO has proposed a major investment in a new online service to meet customer demand in the expected economic upturn. To finance the investment, the company would probably have to increase its borrowings substantially.

(ii) The company's external auditors have written to the board of directors commenting on the fact that the company does not have a disaster recovery plan, but might be well advised to develop one.

The board does not have a separate sub-committee with responsibilities for the risk management system.

The chairman of the audit committee tells Sara that business risk, including the need for a disaster recovery plan, are on the agenda for the next board meeting. He adds that it will be important for members of the audit committee to contribute effectively to the meeting, in view of strong views expressed recently by some directors about the lack of value of IDs to the functioning of the board.

Required

(a) Explain the nature of business risk and the responsibilities of the company's audit committee for business risk management.

(7 marks)

(b) What is a disaster recovery plan and how may such a plan contribute to best practice in corporate governance?

(5 marks)

(c) As company secretary, prepare a briefing note to Sara on how to be an effective ID, and commenting on what some of the common criticisms of IDs are.

(13 marks)

(Total: 25 marks)

<u>SUGGESTED ANSWER</u>

(a) Business risk is a term for the risks to a company's business, such that actual performance could be much worse (or better) than expected, due to unexpected developments in the business and its environment in which it operates.

Events or developments in the business may include actions by competitors or changes in the nature of competition, and changes in the demand for goods or services. Changes in the business environment include changes in the general economy and in financial conditions, changes in technology that affect the industry in which the business operates, and political and regulatory changes. Business risk is two-way risk, in the sense that events could turn out either better or worse than expected. Risk management is concerned mainly, however, with preparing for unfavourable changes, and taking measures to reduce their potential impact if they were to happen.

Some industries are more risky than others, in the sense that future developments are more unpredictable, or conditions are much more variable, and the possibility of making significant losses could be high. Similarly some companies might expose themselves to more risk than competitors, for example by borrowing much more (higher leverage risk) or taking bigger financial risks (for example exposing itself to greater foreign exchange risks).

The CSA Corporate Governance Guidelines (NP 58-201) states the responsibilities of the board of directors for risk and risk management, although the board may delegate some tasks to the audit committee. These include the identification of the principal risks, ensuring that appropriate systems to manage those risks are in place and that an internal audit team should be in place.

The board is responsible for determining the nature and extent of significant risks it is willing to take in order to achieve its strategic objectives. This could be explained in terms of deciding the risk appetite and risk tolerance levels for the company. A board may be willing to take greater business risks in the expectation of making higher returns. The audit committee might then be given the task of monitoring the actual risk levels, and checking these against the board's policy on risk.

Broadly, NP 58-201 also requires the board to maintain a sound risk management system and at least annually to conduct a review of the effectiveness of the risk management system (and tell shareholders that they have done so). The board should establish formal and transparent arrangements for considering how they should apply these principles.

In practice, this will often mean giving the audit committee responsibility for advising the board on matters relating to business risk management and the effectiveness of the business risk management system. A good answer will reference Turnbull and the presence of a sound system of internal control.

Therefore, consistent with MI 52-110 (Part 2) respecting Audit Committee Responsibilities, the audit committee (if given the delegated responsibility by the board) should receive reports from management about the effectiveness of the risk management systems that they have established and also about the conclusions of any testing on the risk management system that have been carried out by internal or external auditors. NP 58-201 directs the Board's responsibility for risk management to extend beyond financial controls, as well. The student may also wish to reference Saucier, recommendation 11 to further strengthen this section.

(b) A disaster recovery plan is a contingency plan for what should be done if an event occurs that seriously disrupts the business of an organisation. The Canadian Guide raises several points in the section about Risk Management to help companies prepare for a disaster:

- What is the probability of an adverse event?
- What risk levels are acceptable?
- Is there a Corporate policy dealing with significant risks and how will they be managed in the event of an occurrence?
- What communication strategies are in place to better inform stakeholders of the nature of the adverse event and the impact on operations?
- What adjustments will be made as a consequence of the event and the resultant operational deficiencies?
- Is there a disaster plan?
- What is the category of adverse event? (credit, market, or operational)

A good answer from a Canadian student will both raise and address these questions.

Examples of disasters may be the destruction of a major operating centre due to fire or bombing, or the total breakdown of a major IT system.

By being able to answer these questions, the company would have a plan to address disaster recovery. Such a plan contributes to good practice in corporate governance because it is an element in the business risk management system that should reduce the potential losses from a risk event, should the event occur. It improves the effectiveness of the business risk management system, and the board is able to report on the existence of such a plan to reassure shareholders and other investors that risk is suitably managed by the company.

(c) To: Sara King
From: Company secretary

Briefing note: Being an effective independent director

Guidance on the role of non-executive directors has been provided NP 58-201. Compliance with these guidelines should help you to perform your role as NED effectively.

NP 58-201
NP 58-201 identifies four roles for a I.D.

(i) As members of the board, Independent Directors should constructively challenge and help develop proposals on strategy.
(ii) Independent Directors should scrutinise the performance of management in meeting agreed objectives, and should monitor the reporting of business performance.
(iii) They should satisfy themselves about the integrity of the financial information provided by the company and that the systems of internal control and risk management are robust.
(iv) Through membership of board committees, they are responsible for deciding the levels of remuneration of senior executives and have a prime role in appointing (and removing) directors and in succession planning.

As an Independent Director, you can assess your effectiveness by comparing your contributions to the workings of the board with these key roles.

The ICSA Code and ICSA Guidance note also states that directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively. The amount of time you are expected to allocate to this company should have been agreed before your appointment and specified in your letter of appointment. You should make sure that you meet this commitment.

NI 58-101 (Appendix 4 in the Guide) specifies that an Independent Director should be able to bring judgement, experience and deliberation to the work of the Board

You should also ensure that you receive sufficient induction to understand the company and its business sufficiently, so that you are able to contribute effectively to board discussions and decision-making. If you have not yet received sufficient induction, you should inform the chairman and insist that you receive it.

Improving Board Effectiveness
In order to become effective as an I.D., you should build up recognition among the executive directors of your contribution, and you should seek to develop mutual respect so that you are able to work constructively together. Mutual respect will enable you to combine the roles of supporting the executives in their management of the business whilst at the same time acting as a monitor of their performance.

Decision-making is an important board function. Dey: “where were the directors” states that in order to make effective decisions, it is essential to have timely, relevant, clear, comprehensive and reliable information. If you are not receiving enough information, or if you are not receiving it in good time to study it before board meetings, or if the information is not reliable, you must discuss this with the chairman and insist on measures to deal with the problem.

IDs should supplement their knowledge of the business with the views of shareholders and other stakeholders. This will help them to obtain different perspectives of the company’s progress and performance, which might help you to reach better judgements.

Common criticisms of Independent Directors

You should try to avoid the weaknesses and failings for which many IDs in large public companies have been criticised.

(i) Canadian corporate boards have been accused of failing to effectively represent shareholders’ rights.

(ii) Some individuals may hold too many I.D. positions in public companies, more than they can possibly serve effectively.

(iii) IDs may not meet with shareholders frequently enough to understand sufficiently well the concerns and views of the company’s shareholders. Dey and Saucier recommend that the board chairman should ensure that all directors are made aware of the issues and concerns of major shareholders, and that the board should keep in touch with shareholder opinion by whatever methods are the most practical and efficient.

(iv) The Canadian Guide makes reference to the over riding influence of executive directors. If a difference of opinion arises during a meeting of the board, the opinions of the executive directors are likely to carry more weight because they know more about the corporation. Independent Directors may be put under pressure to accept the views of their executive director colleagues. A good answer will also x-reference the King report (’94) and describe from that perspective the relationship between good governance and the development of regions/countries. This can also be applied to the developing parts of Canada.

Conclusion

The effectiveness of IDs in a company therefore depends on a variety of factors. The most important of these are the willingness of the board to enter into dialogue with its shareholders, the commitment of IDs to their roles in the company and the willingness of major shareholders to engage with boards of the companies in which they invest.

4. Newman is a large multinational mining company. It has plans to invest in the construction and operation of a new mining facility in Canada's Far North. In time, the mining operations are expected to employ thousands of workers, many of them from the local area. Canada's Far North has a rapidly-growing native population, education standards are currently fairly low and there are concerns about standards of public health. The region has been divided into two territories which have newly elected territorial representatives. In one territory, there are several different native languages being used.

The board of directors of Newman has made considerable efforts in recent years to promote the image of the company as a 'global corporate citizen'. One of its board members, an executive director, has been given special responsibilities for corporate social responsibility (CSR). In carrying out his work on CSR, this director regularly seeks the advice of the company secretary. They are planning a fact-finding visit to the Far North where the proposed investment is planned and, on their return, the director will report to the board on the CSR issues that the company will need to consider if the decision is taken to invest in Canada's Far North.

Required

(a) How can CSR reporting help define the company as a good corporate citizen?

(10 marks)

(b) As company secretary accompanying the CSR director, prepare a board paper in advance of your fact-finding visit, in anticipation of the issues that the visit may raise. Discuss the risks and opportunities that the company may need to consider with regard to CSR if it invests in Canada's Far North and, in particular, the:

(i) Social issues.
(ii) Environmental issues.

Where appropriate, give examples of current best practice and issues that other companies may have faced in similar circumstances.

(15 marks)

(Total: 25 marks)

<u>SUGGESTED ANSWER</u>

(a) There is a view that the best managed companies are those that are aware of their responsibilities towards all stakeholders and society, as a whole. That is, they should show corporate social responsibility. They do this by having a comprehensive set of policies, practices and programs that are integrated throughout the business operations and, decision making processes that are supported and rewarded by top management. CSR includes:

- Minimizing damage to the environment
- Promoting sustainable business development
- Having liberal employee policies
- Investing in local communities
- Helping fight crime
- Promoting community integration through volunteerism
- Promoting a better educated workforce and community.

For global companies, being a good corporate citizenship is more difficult to define because these companies operate in different countries with different ethical and cultural values.

Companies may consider good corporate citizenship to be important for several reasons.

(i) Companies may enhance their reputation by acting as a corporate citizen. Although there is no proven connection between reputation and commercial success, it seems possible that a good reputation will improve a company's relationships with customers, suppliers and governments and regulators.

(ii) Companies may be aware of the need to develop sustainable businesses that will be able to prosper in the future in conditions of scarce resources and increasing regulation against pollution. Acting as a corporate citizen 'now', with concern for the environment, can help a company to survive and succeed in the longer term.

(iii) Concern for the community, particularly in developing countries, can have implications for a company's future business. A company might need a healthy, well-educated and skilled workforce. If so, it should be concerned about raising standards of health and education. A company should also be concerned about raising general standards of living within the communities where they operate, because an increasingly wealthy population is a source of customer demand for the company's products.

(iv) Directors and senior management may have a genuine ethical concern about the way in which business is conducted, and might want their company to act in a responsible and ethical way. In addition, companies should want to ensure that their employees do not act is a way that damages society and may be illegal (for example bribery).

(b) To: Board of directors
From: Company secretary
Date:

Risks and opportunities with corporate social responsibility issues

Introduction
I have been asked to prepare a board paper in anticipation of the proposed fact-finding visit by myself and the CSR director, setting out the issues that the visit may raise and the board might therefore be required to consider now or in the future.

Risks and opportunities
Corporate social responsibility issues may create both risks and opportunities for the company. The opportunities are in creating a successful and sustainable business in the long term. The risks might create damage to the company's reputation, and through this, damage to the business.

Investing in Canada's Far North will create particular risks and opportunities of a CSR nature. These are discussed in the rest of this report.

This paper assumes that the board has as an objective that the company should act as a good corporate citizen. Goals related to good corporate citizenship would normally include:

- Issues related to occupational health and safety
- Environmental reporting
- Human capital development (education, training, opportunities for women, opportunities for those previously disadvantaged
- Social investment (native empowerment and training, opportunities for new Canadians)
- Building the local social infrastructure including: hospitals, health clinics, schools, social housing)

(i) Social issues

If the company wishes to act as a good corporate citizen, it should pursue social policies that are consistent with this aim. Investment in a developing country will give rise to several threats and opportunities of a social character.

- An important social issue will be employment and rates of pay for local employees. The company may not have a choice between recruiting local labour (and training them) for certain positions. Nor will it be possible to pay low wages. But the company will need to decide whether to pay above-normal levels of wages, and if so how high the level of wages should be. There could be some risk of paying premium wages. This too may lead to social dysfunction where some workers may not have any place to spend their money, wisely.

- When hiring local labour, the company should have regard to discrimination. There may be a preference for recruiting men rather than women. There may also be racial discrimination. The company will have to consider how it deals with such problems, as it tries to apply gender equity employment policies. There might be some political risk for the company in deciding on its policy for hiring southern Canadians rather than local residents.

- We are told that standard of education in the country are low. The company may therefore consider a policy of educating its employees, or providing funding for wider education within the schools system (for example by contributing to the building and operation of new schools). The risk for the company is that the population will remain under-educated, and so poorly qualified to perform skilled jobs. The opportunity is that by helping to raise standards of education and training, the company will over time raise the performance standards of its work force.

- Similarly there might be serious concerns for public health. A company with CSR concerns will need to consider health treatment for employees (and their families) and possibly for funding wider public health initiatives in the country. The risk from not trying to raise health standards is that there could be high levels of absenteeism in the work force. The opportunities from higher health standards are a more efficient work force.

(ii) Environmental issues

There will also be environmental risks and opportunities to consider when developing our CSR policies in Canada's Far North.

- The company is proposing to build and operate a mining facility. Mining operations involve the consumption of raw materials and parts, and the company should consider its policies on the sourcing of these. A company with CSR concerns should not consume raw materials (such as water) at a non-sustainable or wasteful rate. It should also avoid purchasing raw materials from suppliers who do not have sustainable business policies.

- The company should also try to ensure that the pollution created by its own mining operations (air, water and land pollution) are all kept to a minimum, and that systems for monitoring pollution (and setting targets for reductions in pollution over time) are designed and implemented.

- There are extremes of weather, for example with risks from severe freezing. Certain transportation may be seasonal depending on the condition of the ice roads. If so, our environmental policies should include measures for the protection of our operations and assets against risks from adverse climatic conditions.

Conclusion

This paper has simply set out a list of CSR issues that the board may need to consider. On our return from the fact-finding visit, we shall be able to present to you in much more detail the specific issues CSR issues that would face the company if the board decides to invest in Canada’s Far North.

5. Hans Denkmal ('Hans') is the chairman of Pindrop, a TSX listed company. He is regarded by the investment community as a successful and competent chairman, partly because of his interest in best corporate governance practice. He has strong views about what the role of a company chairman should be, which correspond to the principles and provisions in the NP 58-201.

A major problem has just arisen in his company, concerning the chief executive officer (CEO). The company has reported a big loss on a contract with a major customer, and a reason for the loss appears to be that much of the work on the contract was sub-contracted to another company at a very high price, and the sub-contracting agreement was very unfavourable to Pindrop. The amount of work sub-contracted was very large. It has now been discovered that close family members of the CEO of Pindrop own more than 15% of the company that did the sub-contracting work. When challenged by Hans about this matter, the CEO denied any breach of duty or other wrongdoing. He added that if he was taken to court by the rest of the board of directors, or by a shareholder, he would defend himself vigorously and would expect to receive financial protection in these circumstances from the company's directors' and officers' liability insurance.

Required

(a) Describe the role and accountabilities of the chairman of a listed company, with regard to board effectiveness and investors' expectations of a successful and competent chairman. *(12 marks)*

(b) Explain, with reasons, whether the CEO appears to be in breach of his statutory duties as a director of Pindrop and recommend what action the chairman should take. *(9 marks)*

(c) Explain the nature of directors' and officers' liability insurance and suggest whether this will protect the CEO financially against any legal action by the company against him for breach of statutory duty. *(4 marks)*

(Total: 25 marks)

<u>SUGGESTED ANSWER</u>

(a) The role and accountabilities of a listed company chairman are set out in NP 58-201. The role of the board is to provide entrepreneurial leadership for the company and a key role of the chairman is to provide leadership to the board. Investors will judge the success and competence of a chairman according to the effectiveness of the leadership that is provided.

A chairman is also expected to commit sufficient time to the company and investors will also judge him (or her) according to whether this time commitment seems sufficient.

A successful and competent chairman will be expected to carry out the roles specified in the NP 58-201. This describes the responsibilities of a chairman as follows, in relation to the role of the board.

(1) The chairman is responsible for leadership of the board of directors, and for ensuring that the board is effective in all aspects of its role.
(2) The chairman should set the agenda for the board and should make sure that sufficient time is made available for discussion of all items on the agenda, particularly strategic issues.
(3) The chairman should promote a culture of openness and debate in board meetings. In particular he or she should facilitate effective contribution by non-executive directors and should try to ensure constructive relations between the executive and non-executive directors on the board.

(4) The chairman is also responsible for ensuring that board members receive accurate, timely and clear information (and in this regard should be assisted by the company secretary).

(5) The chairman should also ensure that there is effective communication and dialogue with shareholders.

(6) He should make sure that an effective decision-making process is in place in the board. He should also make sure that the board committees are properly structured and that they all have appropriate terms of reference, so that they can operate effectively.

(7) The chairman is responsible for the effectiveness of other board members, ensuring that directors are sufficiently knowledgeable about the company and involved in its affairs. He should make sure that newly-appointed directors receive suitable induction, and that all directors (including himself) receive suitable continuing development and training. The chairman should encourage the involvement of IDs, and the Saucier report states that the chairman should meet occasionally with the IDs without executive directors present.

(8) The chairman leads the annual review of board performance and effectiveness, and should act on the results of that review by recognising strengths or weaknesses in the board. Where appropriate he should recommend new additions to the board or should suggest that an existing board member should resign.

(9) He should try to develop a constructive relationship with the CEO, although given the situation at Pindrop this currently seems difficult.

Accountability

The chairman should be accountable to shareholders for his success (or failure) in creating an effective board. The accountability of the board as a whole to the shareholders is achieved through the annual report and accounts. The NP 58-201 requires the board to report on its annual performance evaluation, and given the role of the chairman in this evaluation/review, the chairman is accountable through this part of the report. Of note is that the preface to the UK Corporate Governance Code states that chairmen are encouraged to report personally in their annual statements how the Code's principles relating to board effectiveness have been applied. This might be considered by Canadian companies.

(b) In Canadian law, directors have a statutory duty to avoid conflicts of interest. These are situations where the personal interests of the individual are different from (and opposed to) the best interests of his company, and the director would therefore have to choose between acting in his self-interest or in the interest of the company. It is almost certain that the CEO knew about the award of the sub-contracting work to a company in which his family members hold a substantial amount of shares, and it is unlikely that the sub-contracting work would have been awarded without his approval. There was a conflict of interests, because the agreement appears to have favoured the sub-contractor, and might therefore not have been agreed on fair 'arm's length' terms.

It is also a statutory requirement in OSC 61-501 and CBCA 120(3) that directors should declare any interest in a proposed transaction with the company. Because of the shareholding of family members in the other company, the CEO can be said to have an interest in the sub-contracting work, and he should have disclosed this interest to the rest of the board before the contract was made. He did not do this.

In Canada it is also possible that the failure of the CEO to disclose his interest on the sub-contracting work has led to a breach of the Criminal Code (x-reference also CBCA 120(5). A related party transaction is a transaction between a company and a related party, other than in the normal course of business. For most related party transactions above a minimum size, a listed company is required to make an announcement to the stock market giving details of the transaction; send a circular to shareholders giving more details; and obtain the prior approval of the shareholders for the transaction. It might be argued that the sub-contract was not in the normal course of the company's business and so should have been reported and subject to shareholder approval.

In view of the possibility of legal action in this matter, the chairman should proceed carefully. It would be appropriate to take one or two individuals into his confidence – the company secretary and the senior independent director would be suitable for this. In confidence, the chairman should ask the company secretary to seek initial legal opinion about the current situation, to establish whether the CEO appears to be in breach of his statutory duties. His next step would then depend largely on the legal advice received.

(c) Directors' and officers' liability insurance (D&O liability insurance) is insurance purchased by a company to protect its directors and other officers against the cost of legal action for 'wrongful acts'. In Canada, the CBCA 124(6)(a),(b) states that (for listed companies) should be 'appropriate', which should mean that the cover is sufficient to cover directors against all such costs and that the insurance covers all the costs that a director might occur as a consequence of such legal action.

However, D&O liability insurance does not cover a director against personal liability for illegal acts (CBCA 124(3)(5)). If he is taken to court for an alleged breach of his statutory duties, the CEO would therefore not be covered against the cost of any fine imposed by the court in the event that he is found guilty. Similarly if there is a civil action against him by the company or shareholders representing the company, it is unlikely that insurance cover would be available to cover the cost of any settlement awarded by the court. (D&O liability insurance might cover the cost of settlements in a civil action, but it is doubtful whether this would include legal action initiated by or on behalf of the company itself.)

6. The newly-appointed chairman of a TSX listed company has asked the company secretary for his opinion and advice about a number of issues that are causing him some concern. He has discussed these concerns with the chief executive officer (CEO), but thinks that the CEO does not show enough concern for the risks, particularly in view of the fact that the company is in the process of preparing its annual report and accounts. The chairman mentions three issues in particular:

(i) He has been puzzled by the extent of the questions that the external auditors have been asking all members of the board about the going concern status of the company. He thinks it may be because another client company of the audit firm went into liquidation unexpectedly a few months ago.

(ii) He has read reports in the financial media about the growing concerns of some institutional investors about the lack of reliability in the financial reports of many companies. As he is not an accountant, he is not sure what measures can be taken to make sure that financial reporting is reliable. He has tried asking the finance director, but could not follow all of the technical detail that he was given in reply.

(iii) Like many other company directors, he has become much more aware about reputation risk and its consequences, following the events in 2010 involving the tragic explosion and oil leakage at BP's well in the Gulf of Mexico. The chairman thinks that his board should be giving much more attention to the implications of reputation risk for their own company.

Required

(a) Explain the nature of a going concern statement and, using Saucier as a basis for your argument, outline the responsibility of the directors of listed companies in Canada for such a statement.

(7 marks)

(b) Explain the various measures that are taken to provide reliable financial reports to shareholders, or improve the reliability of financial reporting.

(8 marks)

(c) Using the example of BP, or any other example with which you are familiar, explain the possible implications for a major global company, and the possible consequences, of an event that causes serious damage to a company's reputation.

(10 marks)

(Total: 25 marks)

<u>SUGGESTED ANSWER</u>

(a) A going concern statement is a published statement by the board of directors of a company, asserting that the company will remain in business and continue to trade for at least a given period of time, and will not become insolvent or go out of business for any other reason during that time. The company's financial statements are therefore prepared on a going concern basis and assets valued accordingly, instead of at their 'break-up value'.

The Canadian guide provides a perspective about the concept of a going concern(p144). More recently, the OSC staff notice 52-719 provides a discussion of the findings of a going concern disclosure review in the MD&A.

CGAAP principles require management to assess the issuers ability to continue as a going concern. However, the student can make the leap relatively easily by having read Saucier. Saucier notes that it is the Board's role to provide assurance to the shareholders and stakeholders about the integrity of the operation's reported (financial) performance.

The guide references CBCA 155 which includes a provision that the directors should report in the company's annual financial statements any assumptions and qualifications about the company's operations.

Further, a principle of NP 58-201 is that the Board's responsibilities should include the identification of the principle risks of the business (including risks/threats to its viability)- ensuring appropriate systems are in place to manage these risks, and report these to shareholders.

The Board should also be satisfied that a management system is in place for monitoring and controlling these risks.

Saucier (recommendation 14) recommends that either the Audit Committee or the Board should review quarterly financial reports and related financial documents before any public disclosure. Implied in this statement is that the viability of the Corporation is assessed.

The Audit committee (MI 52-109) has a responsibility to review the issuer's financial statements, MD&A and earnings press releases before the information is publicly disclosed. This implies that the Audit Committee ensures management has made an appropriate assessment of the Corporation's ability to continue.

CGAAP (Chapter 8) also requires directors to make an assessment of the corporation's viability and to disclose the nature of any uncertainties (cross reference Chapter 9- Risk Management). The connection between good governance and risk management within this context is also referenced in NP 58-201 (34)(c). Also consider the breach of Fiduciary duty by a Director and the response of the courts (Chapter 6.3)

Guidance to directors (and audit committees) has also been provided in the Canada by MI 52-109. Directors should make and document a rigorous assessment of the company's going concern status when preparing the annual and half-yearly financial statements. During periods of economic uncertainty, it is particularly important for audit committees and boards of directors generally to assess their company's going concern status very carefully, and should not recklessly or deliberately provide misleading information about this matter to shareholders.

(b) A variety of measures may be taken to provide reliable financial reports to shareholders.

(i) The accounting profession should promote reliable financial reporting through financial reporting standards. Ideally, there would be a single set of accounting standards that applies globally, so that all large companies produce financial reports using the same principles or rules, but this ideal situation does not yet exist.

(ii) The independence and conduct of audit firms is important for financial reporting, because investors may rely on the opinion given by the auditors in their audit report on the accounts of a company. To a large extent the impartiality and professional conduct of auditors is promoted through the rules and ethical guides of the profession.

(iii) A board of directors (through the audit committee) should also monitor the independence of the company's auditors, for example by reviewing the conduct of the annual audit. There should also be a policy on giving non-audit work to the external audit firm, as part of the objective of preventing loss of auditor independence.

(iv) One way in which the audit committee might monitor the annual audit and the conduct of the external auditors would be to ask the internal audit department to carry out a review of the annual financial statements and the report to management by the external auditors (as part of the annual audit process).

(v) The board of directors should try to promote transparency in all reporting by the company to shareholders and other stakeholders. Transparency means making the position or intentions clear, and not hiding information. Shareholders are likely to trust the financial statements of a company whose board they consider to be open and fairly honest.

(vi) Directors should be made liable – and aware of their liability – for misleading financial reporting. The potential liability for lack of care in preparing a going concern statement has already been mentioned. The US has more stringent requirements under the Sarbanes-Oxley Act. The Chief Executive Officer and Chief Financial Officer (CFO) of companies registered with the SEC are required by the Sarbanes-Oxley Act (section 302) to provide a signed certificate vouching for the accuracy of the information in the company's financial statements. This makes the CEO and CFO potentially liable personally for the accuracy (and reliability) of the financial statements.

(c) Answers to this part of the question will vary according to the example used by candidates. The question requires a considered (but brief) discussion of the potential consequences for a company of a possible future event that could cause severe damage to the company's reputation.

The 'oil spill' in the Gulf of Mexico, and associated events, had a number of implications for BP ('the company'). These events damaged the company's reputation, but there were other associated consequences that might therefore be associated with reputation risk.

(i) The company came under strong political pressure from the US Congress and administration. Comments and opinions from politicians added to the damage to reputation. The US administration reportedly persuaded the company's board to defer any dividend payments to shareholders because of the cost of clearing up the damage caused by the accident and the cost of compensation payments.

(ii) The political damage had implications for legal and regulatory actions against the company, which faced the risk that it might be prohibited from engaging in future business activities in the US.

(iii) There were also legal implications from the cost of compensation to individuals and organisations that suffered losses as a consequence of the oil spillage. The cost to the company was estimated in tens of billions of dollars.

(iv) The legal implications had a knock-on effect for the financial risks and business risks facing the company. The company needed to obtain cash to make the compensation payments it faced (and create a fund for these payments). There were also rumours in the financial press that the company's financial weakness might make it vulnerable to a takeover bid.

(v) The incident may well have had implications for the company's reputation for both safety concerns and environmental concerns. The company may have spent time and money (before the accident) developing its reputation in these areas. The effect of the oil leak might be to make the company re-consider both its safety procedures (risk management systems) and its public relations and advertising/marketing policies.

(vi) There may also have been some consequences for employees of the company, who might have had to change their views of the environmental 'friendliness' of the company and some public hostility to their company. This would affect the views of the company they work for, and possibly weaken their loyalty to the company.

(vii) The views of investors in the company might be affected by a change of view about its 'environmental friendliness', as well as changes in it s dividend policy and share price.

(viii) There might also be consequences for the company's brands and sales of its products, particularly in the USA where the environmental impact was felt.

Note: Answers should show an understanding of implications for the company that might be associated with ‘reputation risk’ and other views and approaches might be equally acceptable.