

Chartered Secretaries Case Study

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.

1. (a) **As part of the preparations for his meeting at the High Commission, the Chairman has asked Reeta Patel to advise him on the possible implications for Haligen of the events in Freeland and the actions that the company should take. The Chairman has made it clear that he expects Reeta's advice to cover all aspects of the situation, and not be limited by the issues that may be discussed with the High Commissioner, or even the matters that the Chairman may wish to put to the board. Draft a detailed briefing note for the Chairman.**

(20 marks)

Suggested answer

Notes for Chairman on possible issues to be discussed at the meeting with the Freeland High Commissioner

The following points could be relevant to a discussion initiated by the High Commissioner. They involve factors affecting the interests of the company, the interests of the people in Freeland who participate in the clinical tests and the government of Freeland, and perceptions of Haligen in Freeland, in the UK and elsewhere associated with the trials and possible adverse results of using Antivose. Which points are relevant will of course depend on the line that the High Commissioner takes in your discussions. The list below is designed to be as comprehensive as possible.

You have been given a separate note setting out the details of the field trials of our new antiviral drug Antivose, with a summary of the results obtained so far. This includes information on the medical and other assistance that Haligen has given, through the Freeland government, to clinics and rural medical services in Freeland in association with its continuing activities in the country.

We need to check the reliability of the reports, and the options for getting more reliable information. We have representatives in the country, including the third party agency Medical

Knowledge Services plc that is carrying out the drug trials on our behalf, and we have not yet heard what they have to say.

Whatever substance there may be in the reports of deaths in villages where Antivose is being tested, we know that if public attention is focused on the trials there will be aspects of the trials that could attract criticism:

- The fact that a multinational company based in a rich western country is choosing to test new drugs in a poor African country.
- The fact that payments may be made to the people who participate as subjects, and these payments may be sufficiently high to encourage participants to take risks that other potential participants, particularly in richer countries, might not.
- There are ethical implications of providing free drugs and financial support to clinics, and to people in a position of authority who may influence decisions to participate in drug trials.
- The problem of gaining informed consent from participants who are not English speakers.
- The problems that participants in a poor, distant country may have in gaining redress, particularly legal redress, in the event of harm.

We have members of staff in Freeland who handle external communications implications in the normal course of such trials. As you know, Ben Short is dealing with corporate communications for the whole company pending the appointment of a replacement for our Corporate Communications Director, Charlie Martin, who has left the company. We have corporate communications advisors in the UK who can advise on handling communications in a crisis concerning public perceptions of the company, if that is what is developing.

As part of our communications in a crisis, we can make a statement about our ethical position, taking account of the fact that corruption is rife in Freeland. Corruption may be a relevant issue irrespective of what Haligen knows or has done.

We can seek legal advice, which we do not have at the moment, on legislative provisions in relation to the law of Freeland, the UK or other countries that may claim jurisdiction or which may take into account what happens in Freeland in making decisions about matters that are within their jurisdiction.

Haligen's drug pipeline is almost empty. Delaying or abandoning testing in Freeland would affect the speed with which we can introduce new drugs to fill the pipeline.

Any delays associated with a crisis in Freeland would affect the shareholders' perceptions of the reliability and potential profitability of the company, and in turn would affect the cost of capital and shareholder value.

There may be other reasons for the High Commissioner inviting you to meet him. Our other activities in Freeland, referred to above, have generated a lot of goodwill for the company.

You may wish to consider whether there are any implications of dealing with any crisis in Freeland while we are still dealing with problems related to the chlorine gas leak.

- (b) Draft an agenda for an emergency board meeting on the chlorine gas leak (together with notes on what is likely to be discussed under each item).**

(5 marks)

Suggested answer

Draft agenda

- (i) Who is dealing with the crisis?
- Reports from Ben Short and Joe Burton.
- (ii) Current situation and damage assessment.
- How the people in the plant have been affected.
- How the public has been affected.
- The condition of the plant.
- Effects on output.
- How supplies to customers and other Haligen plants have been affected.
- Reactions of customers.
- Liaison with Health and Safety Executive.
- (iii) Arrangements for managing the crisis.
- Crisis manager and back-up.
- People with whom communications need to be maintained.
- Lines of communication.
- Designated spokesman and back-up.
- Structure for handling the crisis (crisis centre, communications, press facilities).
- (iv) Public communications.
- Who is responsible for recovery?
- Repairing the plant.
- Replacing lost output.
- Retaining customers.
- Obligations to staff and local community.
- Timetable for action.
- (v) Costs to date and forecast.
- (vi) Legal implications.

- (c) Prepare a briefing note for the Chairman on the directors' service contracts to help him in dealing with the question posed by the journalist.**

(5 marks)

Suggested answer

Briefing note for Chairman: request for directors' service contracts

It would be advisable to provide the information required, since it is available to shareholders and to non-shareholders on payment of a fee so the journalist will be able to access this information whether we agree to provide it or not.

If the journalist shows any determination, reluctance to comply with the request would therefore achieve nothing in terms of avoiding publicity, should Haligen wish to do that, and could encourage an adverse report if the company appears to have something to hide.

Being forthcoming will make it more likely that the journalist will rely on Haligen as a source of information and not seek information from other, less sympathetic, sources. It will maximise the opportunity for the company to put its case in support of the current arrangements.

You need not volunteer information that is not in contracts but it is worth bearing in mind that the journalist may have picked up on other matters, such as pension and mortgage arrangements for directors, and may want to ask supplementary questions. If this happens I would advise you to say nothing and we should seek legal advice.

2. Identify the actual and potential financial and ethical problems associated with the setting and achieving of the 2010 profit target.

(20 marks)

Suggested answer

The availability of sales in the current environment to reach the profit target has financial implications, as do the levels of prices and sales margins. Pam Carter considers that the profit target will be difficult to achieve. Joe Burton's conversation with Pam Carter about warranties and depreciation policies suggest that he thinks the same.

While the current interest should be covered by operating profit even if the target operating profit is not achieved (the cover last year was 2.7 times), the dividend may not be covered by current after-tax earnings if there is only a small shortfall in profit (the dividend last year was covered 1.29 times by earnings). Shortfalls in achieving any financial targets will adversely affect investor sentiment, reducing the share price further and raising the cost of capital.

Reducing the interest charge would increase the interest cover, but since the interest cover already looks comfortable this might not be of any particular benefit. On the other hand, since the dividend cover is only 1.29, the benefit of a reduction in the interest charge in terms of improved dividend cover could be significant. Any change in the capital structure, by extending the redemption period of the debt or replacing debt by equity would depend on other considerations concerning financial risk and costs of capital. A decision to change the capital structure should not be based on the effect of a change on one year's earnings. Any suggestion to make a change on this basis should be viewed with suspicion.

Sir Edward Parker's suggestion about the interim dividend could have the effect of improving investor confidence in the short term. Pam Carter knows that following this through with an increased final dividend could leave the final dividend uncovered by earnings, which would have the opposite effect. She had good reason to avoid responding directly to the Chairman's suggestion.

Executive directors, particularly the CEO, who will benefit from bonuses if the operating profit target is met may be involved in setting profit targets. This could constitute a moral dilemma. We do not know whether Pam Carter will earn a bonus if the profit target is achieved, since the information in the annual report and accounts relates to a time before she joined the company. But we do know that Benjamin Russell, the previous Finance Director, earned a bonus in 2009. If this bonus was based on achievement of a profit target, this means that he was responsible for measuring the criterion used to reward him.

Joe Burton's suggestion that the warranty provision should be reduced, which could have an effect on his qualification for his bonus and, through the likely effect on the share price, the value of any share options, raises an ethical issue, as does his suggestion about depreciation policy. (We do not know from the case whether Joe Burton has any share options, but the fact that in the past other executive directors, as well as the CEO, have been granted options, makes it likely that, as COO, he does.)

As far as we know, Ben Short is unaware of Joe Burton's suggestions to Pam Carter, though he would stand to benefit in the same way as Joe Burton if changes were made which had an important effect on operating profit.

If the company changes the way in which it calculates depreciation, and the effect is significant, the company may be at risk of producing misleading profit figures. The Auditing Practices Board has published guidance on the circumstances in which companies may attempt to aggressively manage earnings, and auditors are likely to be looking for this kind of thing, particularly when financial conditions are difficult.

While it would be acceptable, as well as indicating her loyalty to her staff, for Pam Carter to do what she could to protect their jobs, the possibility of doing this by making changes of the kind advocated by Joe Burton (if she believes and allows herself to be influenced by Joe's threat) would raise an ethical problem. Making the threat, if that is what he was doing, represents another ethical problem for Joe Burton.

It is possible that the safety offences for which the company has been fined in the past reflect inadequate maintenance or safety procedures. (This is Terry True's view, and the accident at the Humberside plant suggests that it is correct). Safety may have been neglected to save money. Choices about expenditure on maintenance and safety may raise ethical issues. Spending to put right past omissions may have profit implications.

3. (a) **Identify Haligen's stakeholders and suggest (saying how far the information in the case allows you to do this) what their expectations are in relation to the company.**
(10 marks)

Suggested answer

Managers hope to keep their jobs and most aspire to achieve promotion, partly through the growth and increasing profitability of the company. Managers and other staff aspire to higher salaries, either in their existing jobs or through promotion. Those who qualify for profit-related bonuses and sharing options, and those staff who joined before 2005 and belong to the profit share scheme, hope to benefit from increasing profits and a rising share price. Most managers also want fulfilling employment that allows them to use and enhance their skills and develop their reputations.

Non-management staff are mentioned in the list of Reeta Patel's team members, in the reports on the Humberside accident and in relation to the profit sharing scheme. Both managers and other staff often want much the same kinds of benefits – one of which is safe working conditions – though non-management staff may not have access to the same range of financial benefits. Staff of all kinds who still belong to the profit sharing scheme have an expectation of increasing profits from which growing profit sharing payments can be made. All staff are likely to value security of employment and pensions.

Shareholders want an increasing total shareholder return, made up of dividends and share price growth, associated with a level of investment risk that is commensurate with the return. They may also want to invest in companies in a particular industry or business sector, or in companies that take a particular ethical, social or environmental position.

Customers want reliable supplies of goods or services of a suitable quality at acceptable prices. This means that Haligen needs to develop new drugs (which may be a pressing problem), and to ensure that the drugs that it markets are safe and effective (which means testing them properly and gaining well-based regulatory approval).

The general community wants companies that provide economic activity, primarily in the form of jobs but also by paying rent and rates, and which respect and conserve the environment and the general well-being of the community. As an aid to this, the community wants companies which

pursue policies that protect the health and safety of employees and the community. In the present situation, the accident at the Humberside plant and the reports from Freeland illustrate aspects of health and safety practice where the general community has expectations about how Haligen should act – and where these expectations may not be met.

Suppliers want reliable customers, which take an increasing amount of their output and pay on time. The case does not tell us about Haligen's suppliers, but the growth of Haligen's business demonstrates how Haligen, by organic growth or by acquisition or both, is providing a growing demand for its output.

The government wants companies that, in addition to being good corporate citizens, will pay taxes and generate economic activity, primarily in the form of employment.

The industry sectors in which Haligen operates want companies that contribute to a vibrant, dynamic and innovative industry that predisposes customers to buy its products and services and helps to create the conditions for profitable growth of the industry in the future.

Regulators, statutory or other, want companies to comply with the law and abide by the rules. In the particular case of the pharmaceutical industry, this means marketing safe and effective products. The government and other bodies that are party to the development of the UK Corporate Governance Code want companies to operate in accordance with it. The Health and Safety Executive wants companies to operate in a safe manner. To the extent that they are regulators, bodies that set accounting standards want companies to produce financial statements that are not misleading, and which comply with the spirit as well as the letter of financial standards.

(b) Discuss to what extent the objectives of the Haligen management may be in conflict with those of the shareholders.

(15 marks)

Suggested answer

The following areas can be identified, where the interests of management and shareholders may diverge:

Aggressive profit management

Management benefits in the short term since bonuses are more likely to be earned and the values of share options tend to increase if profits in the current year are higher. Joe Burton's bonuses (and other executive directors' bonuses) are an example.

Shareholders may also benefit in the short term. Higher profits in 2010 will tend to make it more feasible to pay the higher dividend that the Chairman is suggesting, even if this increase is not sustainable. In the longer term, lack of transparency and subsequent adjustments to correct overstated profits can be bad for shareholder confidence and share prices. For managers, this may not outweigh the short term benefits of bonuses earned – particularly if they do not see themselves as having a long term future with the company.

Corporate governance and management accountability

Managers' short term interests may be adversely affected by constraints on their behaviour designed to avoid dishonest or unethical practices. The response of Pam Carter to Joe Burton's suggestions about warranties and depreciation will constitute part of the implementation of Haligen's corporate governance policies.

Enforcement of appropriate standards of behaviour on the part of managers tends to benefit shareholders in the long term through greater transparency and consistency (though they may

benefit in the short term by behaviour that maximises profits, even if there are ethical objections to the methods used).

Scope of business

There may be a case for disposing of the speciality chemicals business, or the consumer products business, or both. Were this to happen, employment opportunities for managers would be reduced. Some might lose their jobs following rationalisation by new owners. The total size of the company would be reduced (assuming that the proceeds of a sale were either returned to shareholders or used to reduce borrowing). It would be harder to justify the levels of pay and bonuses for the directors. The prestige of the directors might be reduced (particularly if the disposal caused Haligen to be removed from the FTSE 100 share index).

If the value of the speciality chemicals business or the consumer products business in the hands of a new owner was greater than its value to Haligen, the company would benefit from a sale. The shareholders would benefit, either directly through a capital distribution or indirectly if borrowing was reduced, reducing interest charges by a larger amount than the profit lost, and also reducing financial risk. Both factors would tend to raise the share price.

However, if disposing of the speciality chemicals and consumer products businesses reduced the total market value of the company sufficiently to cause its removal from the FTSE 100 share index, this would almost certainly cause the share price to fall. Since these two businesses are much smaller than the pharmaceuticals business, the chance of this happening may be small. But the company ought to consider this risk in making any divestment decision.

Company reorganisation and job security

There may be a case for reorganising the company's reporting lines, for example to simplify the reporting lines for the 19 plant managers who all report to Joe Burton, and to focus management attention on businesses rather than functions. This might be to the benefit of shareholders (and could be part of what the Chairman and CEO have in mind). If it made business sense, it would by definition be because it promised greater returns for the shareholders (one which justified any short term reorganisation cost).

If a change of this kind was made, it might create benefits in terms of new employment opportunities and better working arrangements for some managers, but it would have adverse consequences on others in terms of relocation, adjustment or unemployment. Similar considerations would apply, and similar contrasts could be drawn, between the interests of shareholders and managers in the event of a reshuffling or cull of senior staff.

Management benefits

A reduction in pay and bonuses would be unequivocally detrimental to managers' interests. Whether it would be in shareholders' interests would depend on how effective salaries, pensions, bonuses, share options and other benefits are in attracting, retaining and motivating capable managers who would not be attracted, retained and motivated without them. The fact that institutional shareholders are increasingly tending to challenge benefits such as share options in other companies suggests that the case for such payments has, to some extent, been made by default in the past.

The performance of individual Haligen directors, including Joe Burton and Harry Fisher, had been criticised. This suggests that some management benefits may not be working as intended. The criticisms of shareholders and the financial press, and the views of brokers in general, suggest that other Haligen directors may not be giving value for money.

4. (a) **Comment on the performance and prospects of Ben Short, Joe Burton, Sir Edward Parker and Terry True.**

(10 marks)

Suggested answer

Ben Short has been CEO of Haligen for just under a year. The Chairman, Sir Edward, has given him scope to show what he can do, even to the extent of putting his own reputation at risk. With all the resources of a large multinational company at his command, Ben should be able to put solutions in place for problems such as a poor safety record. He has not done so, even though the specialist expertise needed can be provided by Terry True (and perhaps also by Harry Fisher). And he has not yet got to grips with the company's capital structure and its very high gearing at what appears to be an excessively high rate of interest, or with the need to develop new drugs. He may claim that his new and promising Finance Director is only now forming a view of what needs to be done. But the number of problems that beset the company seems to be growing. One crisis has already broken with the chlorine leak, and another may be about to do so (with the reports from Freeland), which test the wisdom of Ben's decision to deal with corporate communications and public relations himself.

Ben could have done more by now to lighten his burden, either by replacing Charlie Martin, by more closely involving external professional advisers or by seeking advice from Lord Andrews. Sir Edward has been tolerant of Ben's learning process, but this may be a luxury that cannot be afforded much longer. His patience must be wearing thin.

Joe Burton seems not to be working effectively with some of the colleagues with whom he has to work most closely. Ben Short may have been concerned that Joe's apparent lack of interest in the causes of the Humberside accident meant that Joe had something to hide. This need not be the case, since Joe's immediate brief was to deal with the production consequences of the accident. Perhaps one decision that Sir Edward has to make is whether Joe's abrasive approach is due in part to an excessive span of control, and, if this were to be changed as the result of a change in the organisation, whether he would then be able to do better in terms of his working relations. What Sir Edward has heard outside the company suggests not. Whether as a result of a general reshuffle of the organisation or as an individual decision, Sir Edward may have to terminate his employment.

Terry True is generally recognised as having done, and continuing to do, an excellent job. He is cautious about taking initiatives where he feels that his lack of director status would make it difficult to impose himself on colleagues who are not doing the job right (with particular reference to safety). Perhaps this is why Sir Edward wants to make an appointment from outside. If there is to be a wholesale reorganisation of the company, Sir Edward may want a strong personality to help manage change. For the time being Terry True looks like 'a safe pair of hands'.

Sir Edward himself has been with the company for just over 18 months. He joined it at a time of near panic for many companies, when it was not clear whether the international banking system was about to collapse. He was in charge, and the company (like most others) survived. Now further change is needed. Problems that are specific to Haligen have to be addressed. Some may be nearly insoluble. As Chairman of the appointments committee as well as Chairman of the board, Sir Edward can claim credit for one apparently successful directorial appointment (Pam Carter) and other appointments of promising senior managers (including Reeta Patel), but he was also responsible for appointing Joe Burton (admittedly with strong support for Joe from Ben Short) and for appointing Ben Short himself.

Sir Edward may well be able to cope with the repercussions of the reports from Freeland and the journalist's request concerning the directors' contracts and even, should he need to be involved, the accident at the Humberside plant. But there are other problems, related to the organisation of the company and the ability of the directors to work effectively together, that may require decisive action. Sir Edward's own future may depend on the nature and success of such action.

(b) Discuss the case for making changes in the businesses in which the company operates and the organisational structure of the company.

(15 marks)

Suggested answer

Business mix and focus

The speciality chemicals business and the consumer products business did not make an important contribution to the company's total operating profit in 2009, particularly outside the UK. It would be wise to check whether this pattern has been apparent in earlier years. If it has, and comparisons with other companies can be made, it may be possible to conclude that these businesses would be worth more in the hands of a different owner (possibly one that could achieve economies of scope or scale by integrating them with existing businesses). If that was the case, Haligen should consider disposing of them, with the objective of getting a price that reflects their value to a better placed owner. This could allow the company to focus on pharmaceuticals, which contribute 74% of its turnover and 84% of its operating profit.

Organisation structure

The company seems to have an organisational structure based on functional responsibilities. The COO's remit covers the whole company, with all 19 plant managers reporting direct to him, and the engineering director is responsible for providing technical input to three different business areas in three continents. The effort involved in coping with this diversity may be one reason why Harry Fisher, by all accounts a highly capable engineer who has successfully familiarised himself with pharmaceuticals production in addition to chemicals, is having difficulty in making the transition to his role of main board director. Even his engineering responsibilities may amount to more than it is realistic to ask one person to do. So far as Joe Burton is concerned, his working relations suggest that another excessively demanding job is being made almost impossible by an inappropriate management style.

It seems likely that the company's functional structure has survived from the earliest days of the company, when reporting lines were shorter and the number of operating units was smaller. Whatever the quality of the management, some of the tasks involved in running the business have expanded to the point where they can no longer be carried out effectively. There is a case for reorganising the company so that the role of the three business divisions is made more prominent and different skills and knowledge can be focused where they are needed to run the different business areas. While this change should be made primarily so that each business area can be effectively managed, a change in the organisation might have incidental consequences that could be beneficial to the whole company. The performance and suitability of senior staff would have to be reviewed and roles would have to be redistributed (probably with three divisional directors on the main board. The different businesses would be more clearly separated as individual, free standing units, with all of the sales, research (if any) and production activities concentrated separately for each division. The case gives no evidence about how such a change in the company's organisation would affect the costs of management and administration, or indeed whether greater focus on individual businesses would increase sales effectiveness, business efficiency and profitability. But it would remove some symptoms of an organisation that has been stretched almost to breaking point.

Merger

There could be an even more drastic option: a driving force in mergers between pharmaceutical companies in recent years has been the scope for savings in research costs. The summary information for 2009 shows pharmaceutical research costs of £656 million and other unallocated expenses of £336 million (out of pharmaceutical operating profits of £908 million). The scope for savings is clear. What is more, there is some doubt about the company's capacity to develop an

adequate range of new products (as shown in the press comment) and to fund research activities.

In a market place that is likely to get tougher rather than easier over the next few years, other pharmaceuticals companies are likely to be looking for ways to cope with pressures on prices and margins. Sir Edward or Ben Short may be looking for a buyer for the whole company.

The scenarios included here are entirely fictional. Any resemblance of the information in the scenarios to real persons or organisations, actual or perceived, is purely coincidental.