SOLUTIONS TO END-OF-CHAPTER QUESTIONS CHAPTER 17

RECALL AND REVIEW

Question 17.1

Information asymmetry arises when one group has more information than another group. Directors run the business on behalf of shareholders. Thus, directors have a great deal more information regarding the day-to-day operations of the business, while the only source of shareholders' information about the company is the annual report prepared by the directors. This creates information asymmetry between directors and shareholders. The agency problem arises because the aims and objectives of directors (agents) and shareholders (principals) are not the same. This means that agents will act in their own best interests and not in the best interests of the principals.

Question 17.2

- The key parties involved in the corporate governance process are shareholders, the board of directors, internal audit, external audit and the stock exchange.
- Shareholders appoint the directors and the auditors and satisfy themselves that an appropriate governance system is in place.
- The board of directors is responsible for running the company. The board of directors is made up of both executive and non-executive directors. Executive directors run the company on a day-to-day basis and are responsible for the management of the company. Non-executive directors do not engage in any management functions but run the board and the various board committees that monitor the performance of both the company and of the executive directors.
- External audit is a mechanism to address the agency problem. Directors prepare the financial statements, but they are interested in pursuing their own best interests. Therefore, the directors may present the annual report in the most favourable way in order to secure greater financial rewards and continued employment, instead of presenting a completely true and fair view of the company and its performance to shareholders. Shareholders appoint the external auditors who are qualified accountants to review the financial statements and verify that the financial statements present a true and fair view of the financial position, performance and cash flows of the company.
- Internal audit is set up by the board of directors. Internal audit is undertaken by individuals within the company. While external audit is focused on the truth and fairness of the financial statements, internal audit has a much broader remit by focusing on the entire range of organisational operations. Internal audit reports provide evaluations of every aspect of a business's activity with a view to improving those activities.

- The stock exchange establishes a rule book to ensure that listed companies comply with the mandatory listing rules in order to protect investors and to uphold the highest standards of conduct in the companies listing their shares.

DEVELOP YOUR UNDERSTANDING

The outline answers to Questions 17.3 to 17.5 provide indicative content only. Your own answers should be much more extensive and include additional ideas and discussions to those suggested below.

Question 17.3

The rationale behind the requirements of the Corporate Governance Code:

- The starting point for this explanation is shareholders' delegation of the running of the companies in which they invest to directors.
- This delegation gives rise to various concerns on the part of shareholders which the Corporate Governance Code aims to remove.
- As agents of the shareholders (the principals), the assumption would always be that the directors are acting in their own best short-term interests and not in the best long-term interests of the shareholders.
- This delegation also gives rise to information asymmetry on the part of the shareholders: because they do not run the company, shareholders know only what they are told by the directors in the annual report and accounts and at the annual general meeting. These are the only two mandatory ways in which communication between directors and shareholders takes place, so shareholders have to make sure that they are being given the full facts and that nothing is being hidden from them at these two communication points.
- Directors, on the other hand, run the company so they know a very great deal about the company and its workings, what is going well and what is going badly. However, they control the flow of information to the shareholders and can disclose only what they have to disclose in the annual report and accounts rather than the full facts.
- Shareholders may worry that company operations are out of control or that directors are paying themselves excessive amounts of money at the shareholders' expense.
- As a result of these concerns, Corporate Governance sets out best practice to ensure that:
  - Directors are working in the best long-term interests of the shareholders.
  - Directors communicate regularly with shareholders.
  - The financial statements present a full and unbiased picture of the results for the year and of the financial position at the end of the year.
  - Directors are not paying themselves excessive amounts of money at the shareholders' expense.
  - The board of directors works as a unit to direct the strategy and operations.
  - Decision making is through the agreement of the board of directors and not based on individuals taking decisions on their own that pose high risks for the company.
  - Operations are fully under control and are not subject to excessive risk taking.

  - Directors are not engaging in any illegal or morally or ethically suspect behaviour while engaging in company activities.
  - There are checks and balances built into company boards and company operations to prevent excessive power being exercised by one person or one small group of persons.
  - Monitoring of company activities by internal auditors and of company reporting by external auditors takes place regularly in order to uncover problems before they pose a threat to the long-term existence of the company.
- Conclusion: the delegation of authority to directors to run companies gives rise to various potential issues due to agency and information asymmetry problems. Corporate Governance Codes and the Companies Act 2006 seek to ensure that boards of directors take various steps to allay those fears and to establish a process of control over the directors to ensure that shareholders' long-term interests are safeguarded to ensure companies' long-term sustainable success.

» Question 17.4

The rationale behind corporate social responsibility reporting:

- As an introduction, your answer should present the fact that shareholders invest in companies and put their capital at risk, so it has traditionally been the case that the focus of legislation has always been on directors' accountability to shareholders with no consideration given to other parties interested in a company's performance.
- However, you should then make the point that shareholders are not the only stakeholders in a company.
- Stakeholder theory requires companies to consider the interests of all interested parties.
- Thus, employees build their careers in companies so have a stake in the success or failure of the business. Loss of employment will affect employees' livelihoods, families and society as valuable skills and experience go to waste.
- Customers buy companies' goods and services so have an interest in how the business produces its products, whether they meet all health and safety legislation, whether they have been produced ethically and whether the companies treat their workers well.
- Suppliers also have a stake in companies as they build up trade relations and have an interest in the continued success of the business. The collapse of a customer has a knock-on effect on the continuity of their suppliers who could also collapse if a source of trade is suddenly lost.
- Businesses exist to serve society so the general public has an interest in ensuring that companies' values and aims are the same as those of society as a whole.
- Companies are not closed off from the world, so their actions have an impact on society and the wider world through, for example, the pollution of the natural environment.
- Therefore, businesses are accountable for their actions to a much wider range of interest groups than just shareholders and should be focusing on a wider range of performance indicators than just profit.
- All interest groups require information about a company's operations.
- Conclusion: the interconnectedness of businesses and different user groups and society provides the rationale behind businesses providing corporate social responsibility reports with a focus that is much wider than the traditional focus on the information needs of just the shareholders.

» Question 17.5

The importance of sustainability as an issue for businesses today:

- The starting point for your answer should be to show that the pursuit of profit tends to be a short-term aim whereas companies should be pursuing long-term objectives to fulfil the demands of their investors who prioritise long-term sustainable success over short-term profitability.
- Sustainability is thus about long-term survival and long-term interests and not just the achievement of short-term profit.
- Adopting a long-term view will ensure that profits are generated far into the future from businesses that are long lived and successful. Profits may be lower today, but the investment of time and resources with a long-term view will pay off many times over in the future.
- The sustainability agenda recognises that natural resources are scarce.
- These natural resources have to be looked after and conserved for the future operation of the business as well as for future generations rather than being fully exploited today with the result that nothing is left to ensure the continuity of supply and demand.
- Just as we save money today to meet the risks of an uncertain future, so companies save today on the resources they use just in case supply of these resources becomes uncertain or increasingly expensive in years to come.
- Sustainability can also generate higher profits: looking to conserve resources gives rise to cost saving opportunities through the reduction of inputs which will then result in reduced production costs and higher profits.
- Adopting a sustainable approach can also lead to competitive advantage. Firstly, reducing inputs will result in lower production costs, which means that selling prices can be lowered thereby generating higher sales. Secondly, consumers tend to favour companies who share their values: consumers who adopt a sustainable and environmentally friendly lifestyle will thus favour companies which adopt the same values and approaches in producing their goods.
- Adopting a sustainability agenda is also about being a good corporate citizen, reducing the harm and damage done to the environment and to local communities whose resources are used in production.
- A sustainability approach reduces organisational risk. Sustainable companies are much less likely to suffer fines as a result of environmental legislation breaches. Such reductions in risk are looked on favourably by lenders who will be more willing to advance money to sustainable companies and at lower rates of interest.
- Companies which adopt a sustainability approach are looked on more favourably by the stock market which recognises the long-term focus of such companies. Traders in the markets will mark the share prices of these companies higher as they are likely to survive and generate rising profits in the long term not just in the short term.
- Conclusion: sustainability makes good business sense due to the advantages gained by adopting such a philosophy. A sustainability agenda means that shareholders' demand for long-term success is met in full.

» Question 17.6

The role of the audit committee according to the Corporate Governance Code is:

- To monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them.
- Where requested by the board, the audit committee should provide advice on whether the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's position and performance, business model and strategy.
- The audit committee should review the company's internal financial controls and internal control and risk management systems. It is also tasked with monitoring and reviewing the effectiveness of the company's internal audit function and assessing the effectiveness and independence of the external auditors. The audit committee makes recommendations on the appointment, re-appointment and removal of the external auditor for the shareholders' consideration. Where the external auditor's independence appears to have been compromised, the audit committee can recommend the removal of the external auditor to the shareholders.

» Question 17.7

The Corporate Governance Code emphasises that a clear division of responsibilities should exist within the board of directors. The executive directors are responsible for running the company while the non-executive directors are responsible for running the board and its committees. Furthermore, the roles of chair and chief executive should not be undertaken by the same individual. Also, in order to prevent the executive directors from overwhelming the non-executive directors, the Code requires that at least half the board, excluding the chair (who is always a non-executive director), should be made up of non-executive directors whom the board of directors considers to be independent.

»» TAKE IT FURTHER

Questions 17.8 to 17.10 are discussion questions. A proper discussion requires an essay which develops arguments carefully and then subjects them to critical analysis. The points set out in the suggested answers to these questions are just outlines which require working up into complete essay discussions with proper introductions and conclusions. Your answers should also include appropriate examples derived from your wider reading around the subject.

»» Question 17.8

The aim of the Corporate Governance Code is control. Your discussion should have focused on the following areas:

- Introduction: in this section, you might look at the historical background to the Cadbury Committee Report, the loss of confidence in business and corporate reporting as a result of various financial scandals and company collapses in the late 1980s and early 1990s. Then note how the aim of the Cadbury Committee report and the proposed corporate governance code was to restore investor confidence in the honesty and accountability of listed and public interest companies.

You could also add the definition of corporate governance in the introduction ('*Corporate governance is the system by which companies are directed and controlled*') and then state that the aim of your essay is to show how the aim of the Corporate Governance Code is control.

- Outline the information asymmetry and agency problems which give rise to the need for complete transparency on the part of directors in reporting financial results and other matters of interest to shareholders. Your discussion should then present the Corporate Governance Code requirements on corporate reporting and demonstrate how these requirements control corporate reporting to ensure that shareholders are given a complete, unbiased view of a company's results and performance for the year.
- Shareholders are concerned with the risk that directors' actions may destroy the companies in which they invest. Therefore, the Corporate Governance Code and the Companies Act 2006 impose limits on directors' actions. Your answer will show what these limits are and how they serve to ensure that individual directors are prevented from excessively risky courses of action which might prove highly detrimental to companies' continued survival. Provisions of the Code also require individual directors and groups of directors to monitor each other and their performance to make sure that everything is under control and working as it should.
- This will lead into a discussion of the oversight provided by internal audit, external audit and the various board committees made up of non-executive directors. These mechanisms aim to ensure that operations are fully under control or will help to bring them back under control should deviations from processes occur. You can show how the different layers of oversight act as a control on one another to ensure that, should one party in the Corporate Governance process miss a problem, another party should pick it up and resolve it successfully.
- Conclusion: the Corporate Governance Code promotes accountability from all parties to the process to ensure that all actions are subject to scrutiny and oversight to ensure their validity in meeting the long-term objectives of the company and to bring to light any risky and value damaging policies. As a result, the aim of the Corporate Governance Code is control.

»» Question 17.9

The only responsibility of business is to generate a profit. Your discussion should have focused on the following areas:

- Introduction: quote Milton Friedman's view in full and then move on to suggest that this view is now rather outdated. Indicate that your essay will seek to show that this view is misguided in the current economic view of the world.
- Show how Friedman's view might be considered legitimate if only a narrow focus is adopted. The view is based on shareholders' provision of capital to businesses and the primacy of shareholders in the financial reporting process. Shareholders take all the risk in financing companies as they could lose everything or gain a very great deal. As shareholders are the providers of risk capital, their returns are all that count hence Friedman's view that directors should not be engaging in any other activity than generating wealth for shareholders.
- However, the more modern view of stakeholder theory promotes the idea that all stakeholders should be considered by companies, because they all take risks and contribute to the overall success of each company. Shareholders might provide risk capital, but employees invest their time and skills in companies (they could work for other companies), customers have an interest in the continued provision of the products, suppliers invest time, money and effort in producing

inputs for products, the public provide their trust that companies will behave ethically and in accordance with the expectations of society and the natural environment provides resources. Therefore, there is a much wider range of stakeholders than just shareholders. All of these stakeholders require information by which to judge the performance of each company and as the basis for economic decisions (for example, whose products and services to buy, which organisations to apply to for employment).

- Outline the benefits of this approach. Companies that report on all aspects of their business and consider all their stakeholders are seen as much more inclusive and trustworthy, they are seen as transparent with nothing to hide and no hidden agenda and they are viewed as good corporate citizens working in accordance with society's values. As a result, they receive a more favourable rating from consumers who tend to favour their products and services thereby increasing sales and profits.
- Discuss the advantages of sustainability and how such an approach improves profits through reduced resource usage, conserves scarce resources for the future and generates increased sales with enhanced competitive, financial, reputational and finance advantages (more detail for these arguments can be found in the answer to Question 17.5).
- Conclusion: a focus on different stakeholders and their concerns and consideration of sustainability will generate long-term benefits for both shareholders and all other stakeholders. The responsibility of business is not just to generate profit but to ensure its long-term survival which will fulfil the aims of the shareholders much more effectively than just a short-term focus on profit.

»» Question 17.10

The proper function of accounting is the measurement of profits and cash flows and the presentation of assets and liabilities. Your discussion should have focused on the following areas:

- Introduction: measuring profits and cash flows and the presentation of assets and liabilities is the function of accounting as shown by the presence of these statements in the annual reports and financial statements of all businesses. However, accountability and accounting extend much further than a simple presentation of results and of an organisation's financial position at one point in the year.
- The measurement of cash flows and profits and the presentation of assets and liabilities show a very restricted perception of what accounting is and its overall role in business. Shareholders are the main consumers of such data, but the modern corporation has a much wider range of stakeholders with much wider information needs.
- Consider the different user groups and their information requirements and how accounting can assist in meeting those requirements. Link stakeholder theory into the discussion to show how directors and managers should be reporting diverse information to meet the diverse needs of different user groups.
- Consider CSR and sustainability reporting and how performance measures beyond the measurement of profits and cash flows and the presentation of assets and liabilities are required to fulfil users' needs in these areas.
- Conclusion: accounting now has a much wider remit in meeting the needs of users whose information requirements cannot be fulfilled simply by a focus on measurement of profits and cash and a statement of financial position.

