
Answers

1 (a) (i) Concepts of sustainability

In the context of the case, SOW meant sustainability in the environmental sense of the word. This means that resources should not be taken from the environment or emissions should not be made into the environment, at a rate greater than can be corrected, replenished or offset. In the case of the Hiaka pipeline, this means that its impact on the environment should not exceed the ability to replace used resources or clean up spills or emissions as they occur.

The government of Exland used the term to mean the sustainability of its economy and the economic sustainability of HEC itself which is such an influence on the national economy. The fact that Exland gets 90% of its oil from one single source (HEC) means that it is disproportionately dependent on the Hiaka pipeline. In all developed and developing economies, oil underpins economic growth and hence the wellbeing of citizens. This applies to jobs, health, education and other essential aspects of Exland's infrastructure. Without a regular and reliable source of oil from HEC, and assuming that Exland is unable to find other sources of oil at reasonable cost, the Exland economy would be badly damaged with a number of unfortunate social consequences.

(ii) Tensions between the concepts

The balance between environmental conservation and economic development is a longstanding one, and one which applies to all parts of the world in which business activity takes place. *A lot of business activity takes place at a net cost to the environment* and so the sustainability of one (environment or economy) *may be achieved only at a net cost to the other*. Some believe that a lot of business activity can be made more environmentally sustainable but the economic costs of this, possibly by accepting a lower rate of economic growth with its associated effects, are often unpopular.

The economies of both Hiakaisland and also Exland are *very dependent on the Hiaka pipeline*. The thousands of jobs on Hiakaisland depend on it, the economy of Exland is underpinned by the oil and the business transaction with Exland is also an important source of foreign currency for the government of Wyland. These benefits all depend upon the economic arguments having ascendancy over the claims of SOW.

Reasons why many are unconvinced by the case for environmental sustainability include the issues of measurement and time perspective. Essentially, *economic value can be measured whilst environmental value is more difficult. Economic consequences can be seen over the short term whilst environmental consequences may not be visible for many years*. Some socio-political structures are thought to militate against longer-term perspectives such as the need to provide short-term shareholder returns (as HEC's shareholders have traditionally demanded) and the length of electoral cycles. In the case scenario, SOW would probably claim to have a longer-term perspective whilst the government of Exland and HEC will have shorter-term perspectives: Exland because its government needs to be re-elected every four years and HEC because it is a public company whose shares are traded on the Wyland stock exchange. The expectations for strong annual returns have, in the opinion of the market analyst, been unhelpful in allowing the company to work with longer-term perspectives.

The extraction of oil is ultimately unsustainable because it requires the exploitation of a non-renewable energy source. In other words, once it is gone, it is gone. The view of HEC's board that it should be 'as sustainable as is economically possible' is unlikely to satisfy SOW and may be seen effectively as no commitment to environmental sustainability at all. Some countries have taken steps to reduce the net impact of business activity including investing in renewable energy (e.g. wind and water power) and both Wyland and Exland could reduce their dependence upon oil by diversifying their energy sources to help to increase environmental sustainability. A lack of dependence on a single energy source (e.g. oil) can also make the country more economically robust, thereby helping its long-term economic sustainability.

[Tutorial note: Allow a range of expressions of these tensions.]

(b) Assessment of the risks and suitable risk strategies

Risk 1 (risk of terrorist attack). Probability is low, with a likelihood of an attack thought to be 10% at some point in the next ten years. The impact of such an event would be very high, however, as it would involve severe spillage and complete supply disruption. This would mean that oil would not be delivered to the port at Hiakatown and this would cause a loss of oil to supply to Exland.

With any risk assessed as low probability but high impact, the usual strategy to adopt is to *transfer or share* the risk. At the same time, however, the company and the government of Wyland would be advised to take necessary measures to *reduce* the probability by instituting suitable security measures such as increased monitoring of the pipeline (perhaps by electronic surveillance or similar). An insurer may share the risk with HEC and, because of the strategic importance of the pipeline to the regional economy and to Exland, the Wyland government may contribute to this effort.

Risk 2 (geological movement and/or earthquake) has an assessed ten-year probability of 5% which is probably considered quite low. The impact that such an event would have, though, would be potentially very high. As has happened elsewhere in the world, seismic activity can cause serious and often catastrophic failure of civil engineering installations. This can result in loss of life and, in the case of the Hiaka pipeline, 'severe long-term supply disruption'. This would be damaging to the Hiakaisland economy and also to the Exland economy.

The strategy for this is also to *transfer or share*. Given the relatively low probability (5% in ten years equates to 0.5% probability in any given year), it should be possible to get an insurer to share the risk for a suitable premium.

Risk 3, the technical failure of a joint in the pipeline, was also assessed as having a low probability of occurring. At the same time, the impact of such a failure, presumably because of the technical design of the joints in the pipeline, is quite low. There is the potential for a disruption to supply but only by a few hours and with no leakage of oil.

The strategy for this risk (being low probability and low impact) is probably to *accept* it. Given that the costs of reducing the risk (perhaps by replacing the joints with more robust ones) would exceed the value of the potential losses, there is no reasonable case for any other course of action. In addition, careful and ongoing maintenance of the pipeline may help to reduce this risk.

Risk 4 is the risk of animal or natural damage to the pipeline. Because of its exposed northern situation, it is likely that much of the pipeline will be exposed to extremes of weather and it is seemingly possible for large animals also to have some effects on the pipeline over time. The ten-year probability for an event such as this was calculated at 60% and, indeed, the case mentions that one such event happened recently, thus demonstrating the vulnerability to this risk. Given the design and construction of the pipeline, however, the impact of any of these risks occurring is quite low, given as 'causing superficial damage to pipeline but no disruption to supply'.

The strategy for a risk assessed as high probability but low impact is to *reduce* it as far as possible. In the case of risk 4, this might mean, for example, reinforcing the pipeline at its most vulnerable points to extreme weather, erecting defences to deter animals where they are most present, or adopting similar risk reducing measures.

Subjective risk assessment

Subjective risk assessment is distinguished from objective risk assessment by how the figures for probability and impact are arrived at. If these figures can be determined accurately and with reference to some certainty, it will be more objective than when an estimate is based more on a 'best guess' basis. Subjective assessments must be treated with more caution than estimates based on more objective data.

In the case of Gerry Jupp's estimates, the case does not say how his figures are arrived at, but it is likely, given that the pipeline is ten years old, that it may be based partly on past performance and partly on a 'best guess' about future events. The estimate of the probability of extreme weather events can be partly predicted based on past weather behaviour but estimation of the probability of terrorist events are likely to be much more subjective.

The outcome of this is that data generated objectively is likely to be more reliable and useful than those based on more subjective probability or impact determinations.

(c) Labour market conditions

The price paid for any good or service (including labour) is related to the equilibrium point between supply and demand. An excess of supply or a reduction in demand will tend to suppress prices whilst a reduction in supply (say of a key skill in the labour market) or an increase in demand for those skills will tend to increase the market price.

In the case of the levels of rewards for chief executives, supply into that market is influenced by the number of suitable people offering themselves for employment and the levels of skills offered by those people. At the same time, organisations buying in the market will seek to match applicants (suppliers) with their own skills requirements. Because there are mismatches between supply and demand, the price rises and falls over time and between countries and regions, just like any other good or service being traded.

Because Hiakaisland is a remote location, it may be difficult to recruit to senior positions in the company. Given that highly qualified and suitably experienced people can potentially work anywhere, they may choose employment openings based partly on non-job related factors such as quality of life issues, climate, levels of infrastructure development, schools for children, etc. In that sense, Hiakaisland must compete with other locations, and HEC must compete with other employers to attract high quality people to work for it and accordingly must sometimes pay a market premium.

Critical evaluation – arguments for

The first argument in favour of paying the 'global' market rate for Mr Hoo is that the company *needs to have a highly skilled and capable person* in charge of its operations and there is unlikely to be a supply of such labour locally prepared to work for a lower rate. As the supplier of a key export and a major employer in Wyland, the regional economy of Hiakaisland depends upon the company's success whilst the people of neighbouring Exland depend upon it for 90% of their oil needs. The costs of recruiting an underqualified or inadequately experienced CEO may be much higher than the reward package paid.

In highly skilled areas such as the market for chief executives, labour markets can be global, meaning that *organisations may buy people from all over the world and sellers (applicants) may go anywhere in order to find suitable work*. This results in a competitive situation for both applicants and employers, meaning that a global equilibrium price (level of reward) can seem high in some countries compared to local labour rates (as in Hiakaisland). If there is no suitable applicant prepared to work for a level of reward commensurate with local rates of pay, the company is compelled to pay the going 'global' rate whether it wants to or not, possibly including a local market premium.

Critical evaluation – arguments against

Where senior management is 'parachuted in' at such a high level of reward compared to local rates, it can make the chief executive in question *appear to be grasping and greedy*. This, in turn, can be bad for cohesion and loyalty in the workplace. It may also affect the motivation of employees and their willingness to co-operate with management initiatives at times. There is an argument that there should be a fixed multiple between the highest and lowest paid in any organisation. This enables the organisation to demonstrate its commitment to fairness, and to respect local sensibilities about rates of pay. By Mr Hoo

accepting a fixed multiple, the company could strengthen its reputation locally and this might create a strategic advantage, especially where the local press and trade unions are concerned.

Because living costs are significantly lower on Hiakaisland than in some of the large cities on the Wyland mainland, the *'real income' on Hiakaisland of a global equilibrium CEO salary is likely to be disproportionately high*. In order to enjoy a comfortable life on Hiakaisland, Mr Hoo does not need a salary equivalent to those living in other, more expensive, places. If rewards are not adjusted for local prices, this not only creates the unrest as reported in the case scenario, but also creates additional costs to the employer and hence poorer value for the shareholders.

With the CEO having such a high salary compared to local rates, it may make it *difficult for Mr Hoo to argue convincingly for cost restraint* or in negotiations with employees or trade unions with regard to their rewards. With his own rewards perceived to be disproportionately high by local labour standards, Mr Hoo may be seen as being hypocritical by those he is in negotiations with and this may affect their willingness to negotiate in good faith or to accept his demands. The idea of a social contract is important in many organisations where all parties must believe themselves to have a 'fair' deal. This can be difficult when one person is seen to have a larger 'slice' compared to others and this, in turn, can affect cohesion and motivation.

(d) (i)

Hiaka Energy
Address line 1
Address line 2
Address line 3

Date

Minister of Industry

Address line 1

Address line 2

Address line 3

Dear Minister,

Thank you for your recent letter on the subject of internal controls at Hiaka Energy Company (HEC) following the Gojo incident. You may be aware that I have just recently taken over as the chief executive officer (CEO) of HEC. In this letter I would like to explain the plans I have for introducing more stringent internal controls and how I believe that a formal internal audit function in the company should help to address issues like that which arose in Gojo in the future.

Turning first to the difficulties in the recent past, you will be aware of the *rough and dramatic terrain* over which the Hiaka pipeline has been constructed. At 1,000 km long, this was a very substantial civil engineering project and required a great deal of technical expertise in its construction. It passes through hundreds of kilometres of a remote area in which accessing the pipeline is difficult. This can mean that a visual monitoring of the pipeline and its surroundings, perhaps for threats like rock slides, can be difficult.

Despite this challenge, the company does implement maintenance encampments at strategic positions along the length of the pipeline. In taking over from the previous CEO, I have regrettably learned that *conditions on these bases are not as comfortable* for workers as I would like and as the workers deserve. One of the consequences is that work in these locations is not seen as attractive, morale is sometimes low and it is difficult to recruit people for this work. This can result in *a lack of motivation and perhaps less attention to technical detail* than is required in providing the highest levels of internal control.

Recent years have also witnessed some *poor industrial relations* between workers and management. You will be aware of the importance of a high level of trust in an organisation and I suspect these problems may have had an effect on the effectiveness of our internal controls. This is not to excuse a lack of attention to internal controls, but it may go some way to explain why things have deteriorated to the extent that they have.

In order to provide the levels of maintenance required along the length of the pipeline, HEC has *relied for some time on foreign labour* acquired from beyond the borders of Wyland. A number of languages are spoken by these people, and it is sometimes difficult to convey detailed technical messages to people when they are uncertain in the language of Wyland. Clear and unambiguous information is necessary in the effective implementation of internal controls and this has not always been possible in the past because of these language problems.

(ii) In addressing these problems, however, I am pleased to convey to you that I have recently gained the support of the board to establish a full internal audit function at HEC reporting directly to the board of directors. I see a number of benefits from this once it is established and operating effectively. I hope this will reassure the Wyland government and our other stakeholders.

Internal audit functions, such as the one envisaged for HEC, have traditionally had four general roles: to address and assure the quality and effectiveness of internal control systems, of risk management, of technical and legal compliance issues and also of the value for money returned to our shareholders and others. I personally see these roles as interconnected and believe that a great deal of benefit will result in the future.

With regard to the *effectiveness of internal controls*, HEC faces a unique challenge with the physical size and geographical spread of its operations. With such a complex operation and so many stakeholders in the successful delivery of energy from Hiakaisland, internal audit will provide an effective control over these operations. The same applies to the *risks which HEC faces*. Our new risk manager, Gerry Jupp, has already begun the task of registering and

assessing the risks, but internal audit will systematise this and ensure that these are subjected to regular and thorough internal audit. This will provide assurance that there are no omissions and that each risk is assessed and recorded as required by the internal audit procedures.

As an energy company working under Wyland law, HEC is subject to both *national regulations and technical rules*. Our new internal audit function will provide assurance that each requirement is taken into account and that the levels of compliance are monitored and corrected as necessary. This also applies to the contractual terms of our supply agreement with the government of Exland. Finally, our new internal audit department will help the company to achieve *value for money*. This is not only important for the shareholders but we are aware that sound financial management is a key part of corporate governance and that we also want to achieve value for our customers and employees. Ensuring that procurements and other asset purchases are best value, for example, will help us to achieve this. Had such an effective internal audit function been in place at the time of its construction, the pipeline could have been constructed within budget and on time rather than being late and over budget as was actually the case.

I hope I have been able to address some of your concerns about HEC and that the company continues to enjoy good relations with the Wyland government.

With all best wishes,

Yours sincerely,

Gavin Hoo
Chief executive

2 (a) Distinguish between rules and principles

Rules and principles are the two general approaches taken to the regulation of corporate governance practice. The United States and Sarbanes-Oxley is the only major example of a rules-based approach, with most countries preferring to regulate governance behaviour through the observation of general principles.

In a rules-based approach such as Sarbanes-Oxley ('Sarbox' or 'Sox'), the legal enforceability of the Act requires total compliance in all details. This places a substantial compliance cost upon affected companies and creates a large number of compliance advice consultancies to help companies ensure compliance. It is the judiciary rather than investors which monitors and punishes transgression and this means that there is no theoretical distinction drawn between major or minor compliance failures. This is sometimes seen, therefore, to be clumsy or un-nuanced as a means of enforcement.

In a principles-based jurisdiction, listed companies are required by the stock exchange (rather than the law) to meet certain standards of compliance. These standards are usually expressed in a corporate governance code. Companies are required, by the stock exchange's listing rules, to comply in detail with all provisions in the code but may, if unable to do so, report to the shareholders the ways in which compliance is not fully achieved, the reasons for the lack of compliance and when the company expects to be back in full compliance. The shareholders may then assess the transgression and take appropriate action themselves. Such action can be in the form of direct complaints to management or investor relations, or reducing their holdings of those shares, thereby reducing company value. In other words, the market rather than the state enforces and regulates compliance and this is thought by some to be a more efficient enforcement mechanism.

Disadvantages of Sarbanes-Oxley and rules-based approaches

The first disadvantage is that costs are incurred in ensuring and demonstrating compliance. It can be convincingly argued that a *substantial proportion of this cost adds very little value to shareholders*, especially in small companies, and resources are diverted to demonstrating minor areas of compliance which could be used more effectively elsewhere (such as in company operations). Because compliance on the 'big' issues is accorded equal weight in law to compliance with 'small' issues, costs are disproportionately incurred in demonstrating compliance in some non-critical areas.

Second, compliance is seen to be an *inflexible 'box ticking' exercise* and this can sometimes mean that companies lose perspective of what are the most important aspects of governance and what can sometimes be a less important provision to comply with. Disproportionate amounts of management time can be used in ensuring compliance in an area which may be less important to shareholders, but which is nevertheless an important 'box' to have ticked.

Third, infringements and transgressions are punished by the state through its judiciary and *not by those most directly affected by such transgressions*: the shareholders. Those in favour of principles-based approaches argue that there is a greater economic efficiency in having governance monitored by those with the strongest stake in gains and losses (the shareholders), rather than the (in comparison) inefficient and undiscerning agents of the state. In many cases, agents of the state are unable to distinguish between major and minor infringements, merely noticing that a 'box' is 'unticked' and pursuing punishment as a result.

(b) Agency

In the context of corporate governance, agency refers to the relationship between the principal and an agent. The principal appoints an agent to act on his or her behalf in order to maximise the outcome sought by the principal. In the case of a business organisation with a separation of ownership and control, this relationship comprises shareholders (principals) and directors (agents). As agents, directors' responsibilities should be primarily concerned with maximising the long-term returns to shareholders and providing timely, accurate and truthful information to shareholders in terms of reporting. The production of reports on internal controls is an important part of this reporting.

Benefits of 'maintaining a system of internal control over financial reporting'

First, the system is important for *ensuring that information can be accessed* as necessary for management decision-making purposes, for reporting, or as part of an audit trail. Information needs to be reliable whenever it is used, either for internal management purposes or for shareholders, and a robust system to produce reporting information is necessary for that. This includes the benefit of the timely delivery of reports.

Second, the case describes the importance of accurate 'evidential matter' in the preparation of reports. This may be important in providing an audit trail and to *demonstrate that the systems and reporting are compliant* with GAAP or other relevant systems of accounting rules (such as IFRS). These make it more likely that the reports will be truthful and reliable, both of which are important information qualities for shareholders. The evidential matter is likely to be able to demonstrate that the contents of the external report have been arrived at by using outputs from measurement systems compliant with relevant standards and this will satisfy external auditors, and, in turn, shareholders.

Third, the report on internal control (IC) is capable of providing *assurance to investors that the company is being well run and that it has effective internal controls* capable of supporting a strategy which can maximise the long-term returns needed. As agents of the shareholders' interests, directors must demonstrate they are responsible stewards of shareholder value. A report on the adequacy of internal controls in place in the company is a convincing way of achieving this.

Fourth, because code compliance is mandatory in a rules-based jurisdiction (Sarbanes-Oxley in the case scenario), the maintenance of an effective system of internal control allows management to *clearly demonstrate its compliance* with the effective laws governing corporate governance. Because there are legal and reputational penalties for any compliance failures (even small ones), the clear and unambiguous signalling of compliance is important to shareholders and the availability of legal sanctions for non-compliance provides greater deterrents and provides greater assurance about the effectiveness of internal controls to shareholders.

(c) Arguments for the exemption

First, smaller companies generally exist in *less complicated environments* than larger companies (i.e. with fewer potential risks and less dynamic risks) and are consequently less exposed than larger companies to some losses. Size confers political visibility and a wider range of stakeholder claims upon the organisation. Furthermore, there is less risk to society and to investors from individual smaller company losses. Whereas a large company with inadequate internal controls and/or poor IC reporting may cause thousands of job losses, large losses to share portfolios and individual investors, there is likely to be less overall risk to society and to general investors if a small company slightly misreports the adequacy of its internal controls. It is also likely that small companies *do not have widely distributed share ownership*, in many cases having the owners being managers. This may mean that shareholders may not need or want the full levels of disclosure of such monitoring compared to larger companies with more distributed share ownership and a greater 'distance' between ownership and management.

Second, there are also likely to be disproportionate costs (compared to output volumes) of putting systems in place for *gathering the necessary 'evidential matter'*. Even when infrastructure is installed, management time is required to prepare evidence of compliance. The preparation and publication of the s.404 report itself can also be *disproportionately expensive* for a small company because of the fixed costs of report preparation which apply regardless of the variable costs of volumes actually produced.

The third reason for exempting smaller companies is that the *fixed costs of the infrastructure systems which need to be put into place are disproportionately high for a small company*. For a larger company which can allocate the overheads of this investment over a high number of outputs, such costs are manageable or even negligible. For a smaller company with fewer outputs, fixed cost allocation per unit may be seen as unfairly high, especially when cash flow is already very tight and the scope for investment in systems for compliance are very limited.

Fourth, the costs of compliance could be a *barrier to growth* for smaller companies and a *disincentive to entrepreneurship*. Many believe that any regulation seen as unnecessarily bureaucratic or which does not enjoy the broad support of those affected by it can discourage value creation. This might mean, for example, that affected companies do not grow as quickly as they might, that they may make lower profits and thereby create fewer jobs.

3 (a) Roles of a nominations committee

Nominations committees have five general roles, all of which are concerned with the recommendation of appointments to the board of directors. The first role is to establish the appropriate *balance between executive and non-executive* directors (NEDs). In some countries, this is influenced by regulation. In the UK, the UK corporate governance code specifies that a half of the whole board should be NEDs. The second role is to ensure that the *board contains the requisite skills, knowledge and experience* to effectively lead the company and provide leadership. Any identified gaps in these requirements should be filled by new appointments. Third, the nominations committee is concerned with the *continuity of required skills, the retention of directors and succession planning*. Fourth, it is responsible for determining the *most desirable board size* given the skill needs, cost constraints and strategies of the company. Finally, the committee is likely to be concerned with *issues of diversity* and to ensure that the company's board is adequately representative of the society in which it operates.

How to approach the task at HWL

In appointing new directors to the board of HWL, the challenge is finding directors who share the values of the charity and who are also prepared to serve at a market discount. The pressure from Marian Ngogo is to find competent people who match both of these criteria and this is likely to be a substantial challenge.

At HWL, the nominations committee could help in several ways with this.

The first is to use *personal recommendations* and business contacts of current or past executive and non-executive directors. In most industries, there is a network of people with similar interests and who are known to each other. These can be used and the recommendations of reliable people can be pursued as necessary.

It could use *search companies* and consultancies to find people likely to be willing to serve on the board. These may have databases of people serving on other charity boards or people who might be interested in working for a charity for a period of time in seeking to serve the wider public interest rather than just his or her own economic interests.

Third, the nominations committee could instruct the human resources function to *advertise for suitable persons*. This is likely to be the most common way of recruiting executives who may be required to have specific technical skills such as accounting or marketing. NEDs are less often recruited in this way.

(b) Advantages of diversity

Diversity policy aims to achieve a board which is demographically representative of the community in which it operates, such that no single demographic segment is over or under-represented. In the case of HWL, a diverse board of directors would provide several advantages.

First, it would make the board *more representative of the community* it is serving, including its donors and supporters. In doing so, HWL would increase its social legitimacy and enjoy a *stronger social contract* with its community and also with the service users. If the board were homogenous with a certain dominant demographic, it would be open to the charge of being aloof and with a weak connection to the local ethnic groups not represented on the board.

Second, diversity on the board will enable HWL to *meet the local government requirements for diversity* and thus to continue receiving that portion of its funding from the local government. With a large proportion of HWL's funding coming from the local government (40%), HWL is effectively required to comply with the diversity requirements as it would be difficult to replace such funding in the short term.

Third, diversity on a board allows the organisation to benefit from a *wider pool of talent* than would be the case with a less diverse board. Having a wide range of demographic segments represented should mean that a wider range of skills, abilities and competences are available. A demographically narrow board would exclude the talents possessed by those outside of the narrow representation and this would be against the board's best interests in seeking to be effective in its duties.

Fourth, a more diverse board would enable a *wider range of views* and opinions to be expressed. The dominant opinion of the majority and the phenomenon of 'group think' can lead to the adoption of positions and policies which can often be shown to be inappropriate in the longer term. So some contrary and challenging voices, especially from those speaking from the perspective of a demographic minority, can be important contributions in policy discussions.

Fifth, a diverse range of people on the board would provide a *greater understanding of the particular values and beliefs* of a wider range of people in HWL's catchment area. Given that HWL's work is most effective when the service providers share some of the values and beliefs of the clients, a board of directors able to understand as wide a range of beliefs as possible is a clear advantage.

[**Tutorial note:** *Some countries are beginning to regulate for diversity on boards. Allow this if placed in a particular national context.*]

(c) Corporate social responsibility (CSR)

CSR is a term used to include a series of measures concerned with an organisation's stance towards ethical issues. These include the organisation's social and environmental behaviour, the responsibility of its products and investments, its policies (over and above compliance with regulation) towards employees, its treatment of suppliers and buyers, its transparency and integrity, how it deals with stakeholder concerns and issues of giving and community relations.

Behaviour in all of these areas is largely discretionary and it is possible to adopt a range of approaches from being very concerned about some or all of them, to having no such concern at all.

CSR can be expressed and undertaken in several ways. It has been the case for some time that companies have exercised a social concern for employees (over and above regulatory compliance) and communities, but in more recent times, the idea has emerged that CSR can be integrated into an organisation's strategy. To be strategic about CSR is to undertake CSR initiatives which can have meaning for the organisation as well as those to whom the initiatives are directed. Ethical 'filters' and scrutiny procedures may be installed to ensure that the company acts in accordance with a set of agreed principles, perhaps expressed in a code of ethics. The organisation's ethical reputation may be viewed as a strategic asset and a key part of its competitive positioning.

CSR at HWL and in a commercial business

As a charity, HWL's *central strategic purpose is to be socially beneficial in nature*. The reason why any charity exists is to pursue a benevolent purpose. In the case of HWL, this is 'to help individuals and families with social problems and related issues.' It performs this service for no charge to the service users and seeks to maximise the quality of this service over other concerns of the organisation. A commercial business is likely to have a strategic purpose framed in terms of competitive or financial measures.

Second, HWL *measures its success in social outcome rather than in profits*. The case scenario says that HWL's strategic (i.e. most important) aim is to deliver its charitable services ('to help its service users') whereas a commercial business is more likely to measure success in financial terms such as returns on investment, net or gross margins, etc.

Third, HWL *supports its charitable purpose* through a number of operational measures. It asks those staff members working for it to *espouse certain values and beliefs* (consistent with those service users being helped). HWL also *asks its directors to forgo income* to work for it. Its attitude towards money was that it would rather spend what money it had on service provision than directors' pay. So asking people to accept a personal discount is perhaps made possible because those who help lead the charity (its directors) are more likely to share a belief in the value of what it does. Such an alignment of personal belief with company policy is rarely asked for in a business organisation and few would ask or expect directors to work for a level of remuneration below the market rate. Increasing personal incomes is often a strong concern of directors in commercial businesses, in contrast with the attitude asked for by Marian Ngogo at HWL.

4 (a) (i) Leaving a board of directors

There are several ways in which a director can leave the service of a board. The first way they can leave is by *retiring by rotation* meaning that upon the expiry of a predetermined fixed term (three years in Frank Bub's case), they do not offer themselves for re-election by shareholders or, having offered themselves for re-election, are not re-elected.

A director can also *resign* at any time with or without a financial pay-off depending on contract. They can be *dismissed for gross misconduct* such as theft, violence, fraud or similar. In some cases, this may take the form of a legal disqualification or disbarment. As with other employees of an organisation, directors can be *dismissed for incompetence*, weak performance or failing to meet targets or similar. In some cases, the director may *fall ill* or be otherwise unable to continue (including becoming incapacitated or dying). Finally, directors will leave the company if the company is *declared insolvent* or otherwise becomes unable to pay and thus retain the services of a director.

(ii) Frank Bub's case

In most cases, probably including Frank Bub's case, the easiest course of action is to allow the current contract to elapse. This is easiest for the company because the fault for the error is partly shared by the rest of the board due to its (the board's) lack of oversight of Frank Bub's activities, and the principle of joint responsibility. In any company with strong governance, such decisions would never be made by a single individual. In Frank Bub's case, the contract elapses in nine months' time. The problem with, say, dismissing him, would be in showing how he failed as a director: it can often be problematic as performance is difficult to assess or evaluate with a small number of performance measures. Whilst he was responsible for the error in the specification, there is a joint liability as others should have signed off on this project too. It may be possible to pay him until his contract expires without having him in a position of responsibility ('gardening leave') or he may agree to perform another role in that time period.

Unless the board supports his re-election, he would be unable to offer himself for re-election by shareholders and so his period of tenure as a director would expire naturally. Assuming there is no expensive termination payment in force on his contract, it should be inexpensive for him to leave the service of the Lobo board.

[Tutorial note: Allow other ways to remove Frank Bub if adequately justified.]

(b) Technological risk

Technological risk concerns the potential losses and damage incurred by the failure of any technology. People often associate technology with computers but it need not be so – it could also be engineering, designs, etc. The impacts of technological risk depend upon those activities which depend upon the particular technology in question. In the case of lost data or a computer storage failure, recent work may be lost, or more seriously, a patient may suffer if a piece of medical technology fails during use. In some financial systems, technology failures can also have very high impacts if all financial data is lost, for example.

Technological risk and shareholder confidence at Lobo

The errors which led to the technology failure were serious and avoidable. Frank Bub had ordered a system which was *unfit for purpose in that it was not correctly specified*. This means that it was not capable of processing the number of tasks required of it and this caused the system to fail when placed under normal loading. Having a person in a senior position capable of this magnitude of error may reflect on the remainder of the board and also its appointments processes and this may ultimately affect shareholders' confidence in the board as a whole.

Second, Frank Bub was seemingly *allowed to make a large investment decision alone* and with no purchasing procedure or controls in place to monitor and assess the quality of such a large asset purchase decision. For something as important as an operational control system, this is an organisational and systemic oversight which reflects badly on the purchasing procedures for the company as a whole. A project team might instead have been formed with technical specialists and product users meeting together to ensure that the system ordered was suitable for the intended purpose.

Third, the system was *not pilot tested* before it was fully implemented. For such an important system as the one which controls the company's main operations, discussion of this project should have been a regular and standing item on the board meeting agendas in the period leading up to its implementation. Thus, shareholders are unlikely to see the blame as being attributable to just one person. Such a major decision should have been taken by the board and full implementation procedures agreed by the board. Therefore, even with the removal of Frank Bub, shareholders may not regain full confidence in the board.

(c) Fundamental principles Frank Bub failed to observe

By over-riding the normal procedures for purchasing at Lobo Company, he acted unprofessionally and failed to observe the fundamental principle of *professional behaviour*. Procedures in organisations are agreed and imposed for good reason,

including, in the case of large capital purchases, ensuring that systems meet value for money criteria and possess adequate operational capabilities. It was by the circumvention of these procedures that the events described in the case occurred.

By purchasing a system unable to cope with the demands placed upon it, and failing to correctly specify the system requirements, he failed to observe the fundamental principle of *professional competence and due care*. In the same way that accountants are employed because they are trusted with certain areas of expertise, engineers are employed because they are trusted with such matters as technical system specifications.

By purchasing the system on the advice of a friend and failing to take further advice beyond that, he was lacking *objectivity* and sound judgement. Professionals should act without bias, conflicts of interest and undue influence in all decisions. When a decision involves a large capital investment such as that at Lobo Company, this criterion becomes especially important as it can affect the operational capability of the business and also, eventually, its strategic positioning.

Public interest

All professionals are required to act in the public interest. Because the status of a professional in society is accorded a special privilege, the requirement to act in the public interest at all times *is an expectation of society*. This applies to professional engineers as well as to professional accountants. An awareness of this would have meant that Frank Bub would have considered a wider range of factors before making the incorrect specification decision.

If Frank Bub was aware of this duty, he *would be aware that he owed a duty of professional care* to 'clients, lenders, governments, employers, employees, investors, the business community and others who rely on the work' (from the IFAC definition of professionals).

Acting in the public interest also reminds Frank Bub that his status as a professional is supported by society in exchange for an understanding that he will explicitly *not act for any sectional interest* or in any way which lacks competence, objectivity or professional care. Because, in the case of his role at Lobo, he is acting on behalf of its shareholders, employees and others, their legitimate claims should be uppermost in his mind in his professional duties.

- 1** (a) (i) 2 marks for each explanation of the two types of sustainability. (4 marks)
- (ii) 2 marks for each relevant discussion point. (8 marks)
- (b) 1 mark for each risk correctly assessed and 1 mark for correct strategy proposed with reason (half mark for identification of strategy only).
2 marks for an explanation of subjective risk and its limitations. (10 marks)
- (c) 2 marks for an explanation of labour market conditions.
2 marks for each relevant point of a critical evaluation of reward level (arguments either way) to a maximum of 8 marks. (10 marks)
- (d) (i) 2 marks for each IC difficulty identified and explained. Half mark for identification only. (8 marks)
- (ii) Half mark for each area identified and 1 mark for each discussed in context. (6 marks)
- Professional marks (4 marks)
- 2** (a) 4 marks for distinguishing between rules and principles.
1-5 marks for each disadvantage explained (half for identification only). (Maximum 7 marks)
- (b) 2 marks for defining agency.
2 marks for each relevant discussion point to a maximum of 8 marks. (10 marks)
- (c) 2 marks for each relevant point convincingly made in support of the case. (8 marks)
- 3** (a) 1 mark for each role to a maximum of 5 marks.
1 mark for each approach for nomination to a maximum of 3 marks. (8 marks)
- (b) 2 marks for each advantage explained. (8 marks)
- (c) 3 marks for explanation of CSR.
2 marks for each relevant difference discussed. Half mark for identification only. (9 marks)
- 4** (a) (i) Half mark for each reason briefly described. (3 marks)
(ii) 1 mark for each relevant point made. (5 marks)
- (b) 2 marks for explanation of technology risk.
2 marks for each problem at Lobo discussed. Half mark for identification only.
2 marks for comment on confidence in the whole board anywhere in answer. (Maximum 8 marks)
- (c) 2 marks for each fundamental principle identified and discussed. Half mark for identification only.
1 mark for each relevant point on awareness of the public interest to a maximum of 3 marks. (9 marks)