
Answers

1 (a) Claims of employees and customers

A stakeholder 'claim' is the nature of the relationship between the stakeholder and the organisation. It describes what the stakeholder is seeking from its relationship: what it 'wants'. In some cases, the nature of the claim is clear and meaningfully articulated but in others, it is unclear, amorphous and unvoiced.

The claims of employees and customers are usually clear, with both being articulated in part by market mechanisms and in part by occasional collective representation. This means that unhappy employees leave and unhappy customers stop buying from the business. The employees of Cornflower, located in Athland, are likely to seek fairer terms and conditions, a safer workplace, both physically and psychologically, and more secure employment and better pay from their employers. In some countries, trade unions or labour pressure groups can express the collective will (claim) of employees. The PWR is an example of this.

In contrast, Cornflower's customers, such as Cheapkit, are looking for a continuing supply of cheap garments. Cheapkit's business strategy is based upon the assumption that such supply will be available, and Cheapkit will have invested in capital (land and buildings) basing its strategy on the assumption of continuing supply at low unit prices. Cheapkit therefore has an incentive to maintain the pressure on Cornflower to minimise its costs, including labour costs.

Conflicts in the claims

A potential conflict between the claims of the customers, such as Cheapkit, and employees is in the control of costs at Cornflower. Because Athland is weakly regulated and corruption seems to be tolerated, Cornflower is able to employ local people on 'zero hours' contracts and, in the opinion of some, on 'exploitative wages'. So the price of helping Cheapkit achieve its low cost position in its own market (the customer), is paid for in part by the poor terms and conditions of Cornflower's employees in Athland. Were Cornflower's employees to receive improved terms and conditions, including working in a safe environment, extended job security and higher rates of pay, these increased costs could make it more difficult for Cornflower to retain its low prices to Cheapkit and hence to Cheapkit's customers.

(b) Explain corruption

Corruption can be loosely defined as deviation from honest behaviour but it also implies dishonest dealing, self-serving bias, underhandedness, a lack of transparency, abuse of systems and procedures, exercising undue influence and unfairly attempting to influence. It refers to illegal or unethical practices which damage the fabric of society. In the case of Cornflower, the Fusilli brothers seemed to have few ethical problems with attempting to influence a number of activities and procedures in their perceived favour. There was seemingly little attempt to allow processes to take their course or to comply in detail with regulations.

Corruption at Cornflower

The case describes Athland as a country with weak regulatory controls. It is evident from the case that Athland did have the requisite regulation in place over such important matters as building construction, escape routes and building occupancy. The problem was the effectiveness of the state in enforcing that regulation.

The first incidence of corruption in the case was the *employment of inferior building materials*. The motivation behind this was to achieve a lower total capital outlay for the building and also a quicker completion time on the project. In both cases, the intention was to make the capital investment lower, presumably to reduce the debt created by the construction and hence the debt servicing costs. Where building regulations specify a certain quality of material, it is usually because that grade or quality is necessary to ensure the safety and integrity of the building when used and under stress.

Likewise, bribes were offered to *persuade officials to provide a weak level of inspection* (effectively to ignore the regulations) when the building work was being carried out. It is common for building inspectors to be present during construction to ensure that relevant regulations are being adhered to. The Fusilli brothers corrupted these officials to the point where they did not adequately perform their duties. In doing so, the officials failed in their duty to the public interest and were complicit in the weak construction that, in turn, contributed to the building's collapse.

Because of the pressure on internal space in the new building, as well as the additional costs involved, the Fusilli brothers were able to have the building completed *without the requisite number of escape routes*. In the event of an emergency such as a fire or similar, the ability of people to leave the building quickly and safely would be a major determinant of casualty and death statistics. Because each escape route takes up a physical amount of space (with the door itself and the pathway needed to allow passage to the door), the space available for machines and other value-adding activity would be reduced and the building would be more costly to construct. This explains the Fusilli brothers' motive to make this illegal change to the plans. More people may have been able to evacuate the building were such regulations adhered to and a safe number of escape routes provided.

Finally, the *occupancy rules were not enforced* by officials. The number of occupants in a building is a legal constraint intended to ensure that over-occupation does not lead to accidents or other safety hazards. The number of people in the building is also a determinant of the evacuation time and, in turn, the risk to the safety of the occupants in the event of collapse. The fact that three times the regulated number of people worked in the building meant that escape plans were rendered much less effective and this would have significantly contributed to the casualties.

(c) Exchange rate risk

Most international transactions involve a currency exchange (unless the countries are in a single currency trading block). Cheapkit needs to pay Cornflower in the currency of Athland whilst selling the garments in its home currency. Because currencies rise and fall against each other as a result of supply and demand for those currencies, an adverse movement of one against the other can mean that the cost of a transaction in one currency becomes more expensive because of that adverse movement. The loss incurred by that adverse movement multiplied by the company's financial exposure is the hazard or impact of exchange rate risk.

The loss to Cheapkit's shareholders can take several forms. The most obvious is the actual loss incurred by an increase in the value of Athland's currency against its own and the consequent increase in costs. This can be a material cost, affecting the buying decision, or it can add to Cheapkit's expenses and therefore reduce its profits on the purchases from Cornflower. In addition though, a large amount of exposure to exchange rate risks can incur risk management costs such as exchange rate 'hedging', as well as the increased uncertainty over the volatility of Cheapkit's profits.

Supply risk

This is the risk that Cheapkit will not be able to obtain the inputs it needs (in this case, garments at the right quality and cost) to sell in its own stores. Increased supply risk is usually associated with complicated or undeveloped supply chains, and dealing with weaker companies in poorly regulated countries. In this case, the collapse of Cornflower's building in Athland means that, at least in the short term, Cornflower will have difficulty in meeting Cheapkit's need for supplies and so this risk has been tragically realised. With approximately half of the 65% of Cheapkit's Athland supplies coming from Cornflower, this incident represents a threat to about a third of Cheapkit's total purchases. Such a large exposure to Cornflower means that Cheapkit is likely to suffer from a shortage of supply as a result of the building collapse.

For shareholders, the value of Cheapkit, and hence the value of the shares, rests upon the successful continuing execution of the business model. Any interruption of supply will mean fewer choices for Cheapkit's customers in its stores with potentially increased prices. In a competitive retail environment, Cheapkit's success, and hence its shareholder value, is dependent on having a range of suppliers to source from, and to play them off against each other in order to achieve the lowest unit costs and the best supply terms and conditions. So the realisation of a supply risk will reduce shareholder value by the offering of less consumer choice and the possibility of increased costs. Both of these will adversely affect Cheapkit's strategic positioning and hence, potentially, its shareholder value. Finally, another supply risk which Cheapkit should have foreseen was the risk that the buildings of a key supplier (Cornflower) *might be vulnerable to such a collapse* as a result of poor government enforcement of building regulations, thus threatening future supplies from this supplier.

International political risk

Political risk refers to a potential failure on the part of the state to fulfil all or part of its functions. It can also relate to any potential influence a government has on the business environment in the country concerned. The state's role is to legislate, to formulate and implement public policy, to enforce justice through regulation and statutes, and to administer the functions of the state (such as education, local services, health, etc). In the case of Athland, the state was believed to be weak in enforcing building and safety regulation, for example, and its failure to adequately do so was one of the causes of the collapse of the building. The ineffectiveness of the Athland state to enforce its own regulations is a realisation of a political risk which not only led to the loss of many lives but also to the loss of a substantial part of Cheapkit's garment sourcing.

International business transactions, including importing from Athland, work effectively when a legal and regulatory environment is in place in all countries dealt with. Contracts of sale and supply need to be enforceable in all countries dealt with, and regulatory controls, such as over the quality of materials, labour and distribution, need to be in effect. All of these ultimately rely upon the stability and effectiveness of the state in which the business takes place. Dealing successfully with Cornflower in Athland, for example, rests upon the assumption that the Athland state is able to enforce its laws and regulations to provide stability in that country. Threats to this include forces of insurrection (uprisings), corrupt officials and other things which render the operation of the state less effective. For shareholders in Cheapkit, the ineffectiveness of the state in Athland means that businesses in that country (such as Cornflower) become unreliable suppliers and this can negatively affect shareholder value.

[**Tutorial note:** Allow for a range of points made on international political risk. The above is indicative of the most likely approach.]

(d)

**Press statement from the board of Cheapkit.
For immediate publication and/or broadcast.**

Cheapkit's response to recent events

This statement is issued by the board of Cheapkit to address several issues of interest to shareholders and which have been raised in the aftermath of the tragic collapse of the Cornflower building in Athland. Cheapkit extends its sincere condolences to the victims and their families.

In response to criticisms made of Cheapkit and other areas of discussion made in the media, Cheapkit would like to make several points to clarify its position on these issues. This is to ensure that stakeholders have full confidence in the company and continue to lend their full support. Cheapkit is a legal, and legally-compliant company, conducting its business in a responsible and diligent manner. It wishes to reassure investors and others that it takes the criticisms made by the PWR leader, Miss Jess Lui, very seriously. We would like to respond to points made in her well-publicised public letter to the board, and also to comment on points raised by several financial journalists about the company's stance on the relatively recent integrated reporting initiative. Any media questions over and above these remarks can, of course, be made to the investor relations department as usual.

(i) Citizenship

The company resents and strongly refutes any allegations that it has been a poor or irresponsible corporate citizen. Cheapkit recognises its role as a citizen, both here in its home country but also in Athland and elsewhere in the world in which it transacts. The board accepts two aspects of citizenship. First, any company such as Cheapkit, with its substantial footprint in society, has to acknowledge its *responsibilities*. Just as an individual has the responsibility to *obey the law, fit in with the social and ethical norms of society*, and behave in an appropriate way, so does a business. Cheapkit is a major employer in its home country and, through its supply chains into countries such as Athland, has a large social and economic impact. Its responsibility is to always comply with the laws and social norms which apply in each country it deals with. This extends to being a good employer, maintaining prompt payment of payables accounts, encouraging good working conditions at supplier companies and similar areas of good business practice.

A second and equally important aspect of citizenship, however, is the exercise of *rights*. Cheapkit is a business conducting legal contracts with suppliers, and selling legal products. As such, it has the *right to be protected by the law* in the pursuit of its normal business activities. In addition, *it has the right to receive the support of society* in the pursuit of business in terms of its investors, employees and customers. It has the right, in other words, to have customers free to purchase products without feeling bad about it, and have employees happy to work for the company without fear of criticism from people believing themselves to be in a superior moral position. The Cheapkit board would remind people that it was not us who occasioned the tragic collapse of the Cornflower building in Athland. It was the negligence and corruption of parties outside our control, and therefore it is unfair to implicate Cheapkit in any criticism directed at Cornflower.

(ii) Accountability and fiduciary duty

We would like to take this opportunity to address two other important subjects, raised in recent media coverage about Cheapkit: the important issues of accountability and fiduciary duty. Again, we feel that much of what has been said has been misplaced and subjective, and we would like to provide comment to counter some of this commentary.

The board of Cheapkit recognises its accountabilities in several ways. We accept the conventional understanding of accountability as an *ability to call to account* and to accept responsibility for something. Of course, a large business like Cheapkit has many accountabilities including *our primary accountability to shareholders*. This primary accountability is discharged in part using accounting statements and annual shareholder meetings, although integrated reporting (see later in this statement) may enhance this accountability further. This is not to say that we are unwilling to work with suppliers, as necessary, to help to improve their employee conditions. In fact, we fully recognise that such improvements would be to Cheapkit's advantage as well as to the employees of Cornflower.

Miss Lui's letter made reference to her belief that Cheapkit has accountabilities beyond that, including our willingness to be called to account for *events in our supply chain*. This is a matter of ethical opinion. It may be a legitimate view but the board of Cheapkit does not share it. It is unreasonable for us to accept responsibility for events over which we have no direct authority or control. Cheapkit recognises its accountability to its shareholders to deliver sustainable returns and would challenge any view which suggests it should be held to account for the behaviour of others in the supply chain, such as Cornflower.

The board also recognises a fiduciary duty it owes to a range of stakeholders. A fiduciary duty, often understood in terms of *a duty of care and trust* which one party owes to another, can be legal or ethical. Cheapkit has *legal fiduciary duties* to its shareholders and employees in that it must comply with relevant laws and regulations relating to how these are dealt with under its duty of care. The board of Cheapkit is appointed to act in the fiduciary interest of its shareholders and must express this through the pursuit of profitable strategies and the management of strategic risks.

As already stated, the extent to which Cheapkit has a fiduciary duty to other constituencies with whom it has no contractual relationship is a matter of ethical perspective. Miss Lui is of the view that the fact that we purchase from a certain supplier makes Cheapkit complicit in illegal and unethical practice at that company. The construction of the building and the conditions of employment for Cornflower's employees is a not a matter over which Cheapkit has any fiduciary duty as this was entirely within the control of Cornflower's management. Some have said that it was Cheapkit's pressure for cheap prices from Cornflower which created the conditions for the tragic events to occur, but Cornflower freely entered into contracts with Cheapkit at agreed prices and was free to withdraw from those contracts if it did not feel able to deliver. Cheapkit's fiduciary duties extend to, and include those, who collectively own the company, the shareholders, and those with whom the company is legally contracted to extend its duty of care, which is mainly its employees.

(iii) Integrated reporting

The Cheapkit board would also like to take this opportunity to respond to some comments made on the usefulness of the relatively recent IIRC initiative and how this might affect the company and its reporting. Like many of the large companies on the world's stock exchanges, Cheapkit is an enthusiastic supporter of integrated reporting (IR).

We see it having a number of potential benefits to the company and its shareholders, but importantly, for many of its other stakeholders also. Designed to be an approach to reporting which accurately conveys an organisation's business model and its sources of value creation over time, the IR model recognises six types of capital, with these being consumed by a business and also created as part of its business processes. It is the way that capitals are consumed, transformed and created which is at the heart of the IR model.

As readers of the business press will be aware, the six capital types are financial capital, manufactured capital, intellectual capital, social and relationship capital, human capital and natural capital. Cheapkit sees three substantial advantages of measuring and reporting performance against these types of capital.

First, the need to report on each type of capital would create and enhance a *system of internal measurement* at Cheapkit which would record and monitor each type for the purposes of reporting. So the need to report on human capital, for example, would mean that Cheapkit and other companies adopting IR must have systems in place to measure, according to the IIRC guidelines, 'competences, capabilities and experience and their motivations... including loyalties [and]... ability to lead, manage and collaborate'. These systems would support the company's internal controls and make the company more accountable in that it would have more metrics upon which to report.

Second, the information disclosed, once audited and published, would create a *fuller and more detailed account* of the sources of added value, and threats to value (i.e. risks), for shareholders and others. Rather than merely recording financial data in an annual report, the IR guidelines would enable Cheapkit to show its shareholders and other readers, how it has accumulated, transferred or disposed of different types of capital over the accounting period. So it would have to report, for example, on the social capital it has consumed, transformed and created and this could include issues of relevance to Miss Lui and others. It might include, for example, the jobs it has created or sustained in its supply chain and the social value of those jobs in their communities, or how it might operate a system of cultural values for its employees. In addition and in the same way as for added value, IR would help Cheapkit to identify, assess and manage its key risks, with this bringing further benefit to shareholders and others.

Third, a fully-developed IR account would show how Cheapkit has created value for *many of the company's stakeholders and not just for the shareholders*. This extends the whole notion of who benefits from a business's activities and it uses the different types of capital to convey this information. So a beneficial increase in social and relational capital, for example, may be of benefit to Cheapkit's communities and suppliers. The requirement to report on this change ensures that those stakeholders who wish to value a particular type of capital from their own perspective can assess the value of the company in that regard and can also assess how the company's value has changed in favour or against their own specific interest in a reporting period. ENDS.

2 (a) Chambon as a public sector organisation

There is a range of ways in which schools are organised. Some are privately owned and pupils are privately supported financially to attend the school. Many such schools do not receive any state funding and are, accordingly, described as being in the private sector. Others, such as Chambon, are public sector organisations. In Chambon's case, it is a public sector organisation because it *receives its funding from central government* ('state-funded'). This means that its budget is funded through state funds (mainly taxation) and it is thus required to deliver value to the country's taxpayers. In addition, the school is under the political control of the local authority. This means that it will be *required to account to the local authority* on whichever targets are set for it. This might include budgetary compliance, teaching quality and pupils' exam performance.

The case mentions that Chambon is *required to teach a national curriculum*, that is, a set of subjects decided at national level and taught at each school in the country. This is to ensure that all of the children being educated in the country (including at Chambon) receive a thorough education containing the subjects specified by national government. In addition, unlike private schools which can organise governance arrangements in more flexible ways, Chambon is required to *observe governance arrangements* set for it by government. These arrangements are likely to include the establishment of an effective board of governors, a means of parent-teacher interaction and the appointment of an effective headteacher. It may also include the removal of a headteacher, by the board of governors, should an incumbent be deemed ineffective in his or her role.

Assessment of Chambon's objectives and whether they have been met

Because it is a public sector organisation, Chambon school will operate in a quite different way to a private sector one. Whereas a private sector organisation's objectives are likely to be concerned with the generation of long-term shareholder value through the ongoing generation of profits, a public sector school's objectives are likely to be quite different. The effectiveness, efficiency and economy ('three Es') model is a useful way of describing whether the objectives of a public sector organisation have been met.

First, to be an *effective* public sector organisation, Chambon exists primarily to educate children and to cultivate an effective learning environment. It does this by employing effective teachers and operating a structure and culture which supports those teachers in their work. Infrastructure such as learning resources, libraries and sports facilities are all important in achieving a conducive learning environment. The closure of a part of the library was a serious threat to this as was the sale of the sports field. Such measures, in turn, may reduce the ability of the school to effectively educate its pupils in future.

The second point of assessment against the three Es model is efficiency. Chambon showed signs of a *lack of efficiency*. Efficiency is defined as the amount of work achieved for a given level of input. Despite budget increases (i.e. higher levels of input), the school's public examinations performance fell. An efficient organisation would have successfully converted the higher levels of resource into outputs, evidenced in the case of Chambon school by better exam results. At Chambon, the increased resources had no apparent effect on exam performance and in fact they deteriorated further, suggesting an inefficient use of those resources.

Third, the school (and the board of governors) *failed to control its budgets* and hence also failed in terms of its economic objectives. The school received higher budgets from the local authority in an attempt to reverse the weak performance and

despite this, it still sustained a budget overspend, resulting in the necessity to close part of the library and sell a sports field. This is a wasteful and irresponsible use of public funds for which the board of governors, in part, must share the blame. It is its role to hold the headteacher to account and ensure that the school is managed so as to achieve its objectives effectively and within budget. It is likely that both the head of school and the governors have been negligent in allowing this to happen.

So on each of the three general types of objectives for public sector organisations, Chambon has failed to meet its objectives.

(b) Board of governors

The roles which public sector oversight boards are asked to undertake varies between countries and according to the type of organisation. In the case of the board of governors of a school such as Chambon, however, there are typically four general roles.

First, the board of governors at Chambon is required to *comply with imposed local authority rules* on school governance including its own structure and terms of reference, reporting rules and receiving complaints about the school's operations. Upon receiving its annual set of public examination results, it is required to report on those. Other duties may be imposed in addition, such as its duty to hear complaints from service users (e.g. the parents of school pupils) and act on these as necessary.

Second, the board is required to *ensure the school is well-run* and that the headteacher is supported or challenged as necessary. The school exists to provide an important public service and to provide value to the taxpayers who pay for it. In this regard, it is for the governors to ensure that an effective management structure is in place in the school and that the quality of teaching, learning and the pupil experience are adequate and capable of delivering the required level of education.

Linked to this, therefore, it is the role of the governors to make *senior appointments and remove underperforming officers* from their positions. It is the duty of the governors to appoint the headteacher and to ensure that he or she is effectively managing the school to deliver the required level of quality and service to the pupils and their parents. In the case of Chambon, there is evidence that Mr Besse is underperforming and the governors are therefore considering his position.

Finally, the board of governors is usually required to *set and monitor budgets* and to monitor management against key objectives. Because the governors are acting on behalf of the local government authority and the funding agent, they have to ensure that there is sufficient funding in place to deliver the required level of services. Once the funding for a year (i.e. the budget) is agreed, the governors must ensure that there is no overspend. This may be achieved by asking for financial information at various points throughout the year to ensure that the budget is met by the year end.

Transparency and Sally Muro's proposal

Transparency is a default position of openness and full information provision rather than concealment. A transparent organisation is one in which all available information is provided unless there is a strong and defensible reason for hiding a part or all of it. In this case, the school and the board of governors have the duty to report in a 'full and timely manner' its exam performance and the reasons for this.

Transparency is important in a school's report to a local authority in the same way that it is in a private sector business. As a recipient of state funding, it must *account to the funding body* (in this case through a local government authority structure) for the way it has used the funding and the outcomes it has achieved. If the school has been effective and efficient, it can report this, using a range of metrics, and thus show that it has provided value to the taxpayer. So reporting is an instrument of accountability and an important way in which governors must discharge this duty.

Second, it is important that the local government authority receives all necessary information on time because it has a statutory duty to manage education services locally and will *use the reported information for planning*. It may have to redistribute resources from one school to another, for example. In countries where education provision is devolved to local government authorities, there is a legal duty placed upon those authorities to provide an effective provision in that locality and this may involve making changes to local schools. The information provided by schools is often an important input into that process and so full and timely provision of that information is important. Partial, incomplete, late or inaccurate data would mean that the local authority would not have the information necessary to make these important decisions.

(c) Potential advantages to Chambon of replacing the headteacher

First, a new headteacher may bring about a *change of culture and staff expectations*. Mr Besse is clearly experienced, but perhaps one reason why he is liked by staff is because he is unwilling to confront underperforming staff. His dislike of confrontation may be one reason why underperformance is tolerated. If an unhelpful culture is allowed to grow and embed itself, it can favour one interest over another. In this case, it may be that the teachers and their conditions have been allowed to be given greater prominence than the quality of the educational experience for the pupils. This could be addressed and reversed with a new headteacher.

Second, a new headteacher *would signal a change* in the school that Mr Besse's regime, with its tolerance of weak educational performance, was over. A new head, with the strong backing the board of governors and the local government authority, would be able to effect the necessary change which Mr Besse so clearly failed to do. By removing Mr Besse, and allowing it be known that it was linked to the deterioration of examination results and financial inefficiency, the governors could convey to the teachers, pupils and parents at the school that his performance was inadequate and a new head was therefore being appointed to improve the school's performance.

Third, a new head would enable the governors, acting on behalf of the local authority, to make the changes necessary to improve exam and budgetary performance. Whilst Mr Besse was resistant to taking such measures, a new head appointed

by the governors *would be a 'new broom'* in his or her approach to changing teaching practices and helping to cultivate the educational culture necessary to turn the school around. By introducing more efficiency, new practices and a new style of managing staff, a new head could introduce a new regime and address the weaknesses in teaching and learning, and control costs more effectively, as necessary.

[Tutorial note: Allow other plausible points of discussion here if relevant.]

3 (a) Roles and qualities of chief executive officer (CEO)

The main roles of the chief executive of a listed company such as New Ideas Company (NIC) are first to *propose and develop strategies* capable of making an acceptable return to shareholders. This involves the CEO having highly developed strategic thinking skills and being able to consider a wide range of potential outcomes and implications when making strategic plans for the business. It is also necessary to ensure that strategies are resourced and so an understanding of investment and the raising of capital is important.

Second, the CEO *implements the decisions of the board*. This means that the various divisions and/or departments in the organisation must work out the strategies agreed, and the CEO must configure and co-ordinate the business to achieve these. This role requires a strong understanding of the business and an ability to relate to colleagues at a high level in a number of specialised areas. Highly developed communication skills are important in this, and the ability to understand the technical and business aspects of the company are both very important.

Third, the CEO must *analyse the performance of all parts of the business* in terms of each one's contribution to strategy and its fit with the rest of the organisational structure. Because successful strategies require all parts of the business, at all levels, to contribute fully, the CEO must have the analytical and processing skills to be able to achieve this. This partly involves analysis of 'hard' numerical data such as variances against budget, etc and also 'softer' qualitative skills such as the ability to assess the human skills and abilities in colleagues and subordinates.

Fourth, the CEO plays the leading role in ensuring that appropriate systems are in place for *internal controls and the management of risk*. The robustness of the organisation's internal systems and their ability to work effectively towards the achievement of strategic goals means that effective internal controls need to be in place, possibly including internal audits. Likewise, a full and detailed knowledge of the risks faced by the business, especially strategic risks, is essential. These roles require the CEO to have multi-conceptual skills and be able to consider a wide range of internal and external issues at the same time. He or she must be able to delegate technical responsibility for these tasks whilst having the knowledge and force of personality to be able to make rapid changes when necessary to respond to new challenges and opportunities as they arise.

Dr Ranjana Foo's suitability

By her own admission, Dr Ranjana Foo is probably ill-suited to the role of CEO of NIC. As the scientist who made the discovery in the first place, she is clearly very able in her own technical field, but this does not necessarily qualify her for the role of CEO. As the scientist who developed the technical product upon which NIC is based, Ranjana clearly has an excellent understanding of the technical aspects of the business. Her limitations are likely to be in analysing the performance of other parts of the business.

As one who prefers to *work alone*, she would be uncomfortable in large meetings such as board meetings where she would be required to interact with people most of the time. Her *preference for a 'quiet environment'* would not be met in the CEO role where she will need to manage other directors and negotiate with others.

In her colleagues' view, *she is good at detailed work but sometimes struggles to see the bigger picture*. This would suggest that her strategic thinking skills are underdeveloped, and this would make it difficult for her to conceive strategic objectives for NIC and put plans in place for their implementation.

Finally, as one who prefers to *avoid confrontation and conflict*, she may be unable to effectively assert her own will and purpose on colleagues who may not fully agree with her on occasions. This is not to say, of course, that conflict is desirable or necessary, but it is sometimes necessary to over-rule one or more colleagues in the interests of the greater strategic good.

(b) Benefits of non-executive director (NED) recruitment at New Ideas Company

As a start-up business, NIC faces a number of challenges. The first is the *lack of business expertise among the scientists*, and particularly with Dr Foo herself. Dr Foo, obviously a committed scientist, is unwilling to invest the time necessary to learn about running a business so will be heavily reliant on the expertise and skills of others in developing the scientific breakthrough into a commercial success.

Because the business is considered risky by analysts, the presence of experienced non-executives is important in *increasing the board's accountability* to the shareholders. With appropriate experience, NEDs can advise on specific issues with start-up businesses, including working capital management and issues capable of affecting cash flow in early trading.

The third benefit of having a suitably-experienced NED presence on the board is to *demonstrate compliance with corporate governance listing rules*. This would have the effect of reassuring shareholders, and the analysts providing information to shareholders, on specific types of businesses. It is important, and especially in the early years of a company's life, to have the confidence of markets. An adequate and fully compliant non-executive presence on the board will help achieve this.

Difficulties in NED recruitment

Despite the increase in non-executive board memberships in many parts of the world, it should not be forgotten that NEDs have relatively little financial incentive for board membership compared to their better-remunerated executive colleagues. In

the case of recruiting non-executives to the board of NIC, the case refers to three specific difficulties which could apply in many regions and not just the one which NIC is located in.

The case mentions that NIC, and the university it grew out of, were located in a *small city away from the main centres of population*. The isolation of some regions makes the chances of locally recruiting an experienced and effective non-executive team very difficult. There is usually very little occupational or geographical mobility ('churn') in such regions with relatively few suitable people being available. There would also be less chance that those available to be non-executives would be sufficiently independent of each other (i.e. they are likely to already know each other quite well through local networks and social organisations).

The *highly technical nature of the company's operations* is another potential difficulty. Given that the company is a highly technical business, it is likely that relatively few people will fully understand the nature of its work and the technical issues behind it. One of the main purposes of a NED is to represent the shareholders' interests on the board and it therefore is necessary for them to have a good understanding of how value is added. In scrutinising the internal controls, risks and the effectiveness of the operations, NEDs need to understand the sources and implications of internal strengths and weaknesses, and also external opportunities and threats. A failure to understand the company's main activities would be likely to deter many potential NED applicants.

The analysts' view, upon reading the company share prospectus, was that, as with many start-up businesses, it was risky. Some predicted that the business could fail within two years. *Uncertainty over a business's future would be a disincentive* for some potential NEDs to commit to joining a board. Some would believe that being associated with a company failure would be bad for their own business reputations and therefore they may be reluctant to join the board as a NED. In the same way, because it is a business which could fail early, the time required to adequately guide and advise NIC may be substantial and more than many would be able or willing to provide. With so much resting upon the successful adaptation of a scientific breakthrough into commercial success, and with a new company start-up developing its own culture and structure, the management commitment required by NEDs is likely to be initially high.

- (c) A conflict of interest arises when a person's ability to act with independence and impartiality is hindered by a countervailing interest held in a cause which could be the beneficiary of decisions made. In the case of directors in a business, any countervailing interest which prevents a director acting solely in the interests of the shareholders of the business can be considered a conflict of interest: he or she must act in the interest of shareholders but may also stand to gain or lose personally by decisions made in his or her capacity as director.

In the case of Dr Idris, his shareholding in the equipment supplier *may reduce his impartiality* when it comes to the choice of supplier to NIC. As a director of NIC, he would be duty-bound to always seek out the best value-for-money for all capital purchases in order to return the highest value to the NIC shareholders. In this role, he should have no interest in any of the potential suppliers which may steer him, in principle, towards or away from any particular supplier.

As a major shareholder in the potential supplier, however, he may *stand to gain personally were the supplier to be awarded the supply contract* by NIC. A large contract would generate cash flows and potential profits to the equipment supplier, increase its visibility and make it more likely to receive future supply contracts. This could increase the value of Dr Idris's shareholding in the equipment supplier and hence he may have an incentive to recommend the award of the supply contract to the supplier even although that may not be in the best interests of the shareholders of NIC. There may be an alternative supplier which would represent better value to NIC and its shareholders.

4 (a) Establishing an internal audit function at Loho Company

Some corporate governance reports set out a number of criteria for a company considering setting up an internal audit function. The Turnbull Report, from the UK, for example, lists seven criteria: the scale and complexity of operations; the number of employees; cost-benefit considerations; changes in organisational structure; changes in key risks, problems with internal control systems; and an increase in the number of unexplained or unacceptable events.

In the case of Loho, the case for establishing an internal audit function has grown in recent years because of five of these criteria.

The successful expansion of Loho in recent years has given rise to some problems associated with *growth and greater complexity* of operations. The case mentions new products and new markets overseas. These, being the two major areas of uncertainty on the classic Ansoff matrix, represent a significant increase in the complexity of the company's operations, and the company is manifestly having issues coping with this change. Effective internal audit systems can scrutinise and report on each part of the organisation and ensure that the complexity of each component is understood and controlled.

The growth and increased complexity has also seen an *increase in the number of employees* from 150 to 600 in its home country and the addition of 200 overseas positions. The configuration and co-ordination of this increased number presents Loho with a considerable challenge if they are all to be usefully employed to maximise each person's contribution. This includes oversight of decentralised activities, especially in overseas offices, and potentially managing the cultural and language issues sometimes occasioned by the employment of overseas nationals.

The case mentions that the company has *become more decentralised* as a result of its growth. It is common for growing businesses to increasingly delegate authority to divisions and departments as they grow, or to regional offices if the growth is geographical in nature. The loss of concentration of power at the centre sometimes raises issues with control and co-ordination of the decentralised parts and so an internal audit can help to ensure compliance of those parts with company

norms and procedures. These decentralised centres must also be configured so they 'fit' with the rest of the organisation and co-ordinated with the overall strategy, and internal audit can help achieve this.

One of the results of the increase in internationalisation is a *change in some of the risks*. Exporting and conducting business in more than one country increases a number of risks and the case mentions credit risk in particular, which is the risk of failing to be paid on time (or at all) by customers. This can severely affect working capital management and so can, in the worst case, threaten the survival of the business if it is unable to meet current working capital liabilities, such as the payment of suppliers. In some countries or in some sectors where cultural factors may mean that credit risk is a material risk, an internal audit department could enforce credit controls and ensure that mitigation systems are in place to manage those risks. It could also perform regular 'stress test' exercises to ensure that credit controls are effective and fit for purpose.

The final argument for establishing an internal audit function is an *increased number of unacceptable events* at Loho. It would appear from the case that the growth of the company has brought about a number of deficiencies in the operations department which have led to the company failing to adequately meet orders through late deliveries. This level of operational performance will threaten the long-term relationships with customers and could rapidly lead to a loss of trust in Loho among its buyers. An effective internal control function could analyse the causes of these events and help to reduce their impact or find ways in which the company's vulnerability to such events can be reduced.

(b) Why the effectiveness of internal controls (IC) cannot be guaranteed

It is generally understood that, however robust and expensive an internal control is, it can sometimes be ineffective. There are a number of possible reasons for this, with the most common being as follows:

The control can be *over or under-specified*. An under-specified control is one which is not capable of actually controlling the risk or activity intended. Conversely, an over-specified control is one which over-controls and may have the effect of losing the confidence of employees and others influenced by the control. An over-specified control is one which is poor value for money and may constrain activity if the control does not adequately allow normal levels of performance. Controls which do not enjoy the support of those affected are sometimes ignored or bypassed, thereby rendering them less effective than they might be.

Human factors can undermine or circumvent the effectiveness of many internal controls. In this regard, the most common is *human error*, which may or may not be accompanied by *intentional fraud*. It is sometimes believed, by an individual, that personal gain could be achieved were a given control not in place and this can result in that person intentionally circumventing the control.

Likewise, controls can be ineffective if *employees collude* to achieve that circumvention. If a group in a workplace believes a control to act against members' personal interests, they can act together to reduce its effectiveness. This may, of course, result in a sanction if discovered.

The fourth reason why ICs are sometimes ineffective is the *occurrence of non-routine events* when a control is designed for relatively routine behaviour. These might include events from any of the PEST influences, for example, which might render the control ineffective, possibly by 'overwhelming' the control or presenting it with a situation for which it was not designed. Linked to the previous point is the occurrence of unforeseen or unforeseeable events.

Management or employees may exercise *poor judgement or miscalculation*, which means that a control will become ineffective. A brake on a machine tool or a vehicle is only effective, for example, as long as the machine is responsibly and safely used. An excessive speed or the use of a wrong material in a machine tool, for example, would negate the value of the brake, even though the brake is effective in its own right.

Relationship to cost

There are several reasons why cost alone is a poor guide as to the effectiveness of internal controls.

First, it is the *design of the control rather than the cost* which is the primary driver of effectiveness. A wrongly or inappropriately designed control, regardless of cost, will be less than fully effective. It is for this reason that a great deal of technical detail is applied to the design of controls, especially those concerning financial risk. There need not be any direct relationship between design and cost. A highly effective control can, at the same time, be very simple and inexpensive.

Second, *a control can be over-specified*, meaning that the control is more robust, and usually therefore more expensive, than it needs to be. Cost-effectiveness is a key criterion to the adoption of any control, and a control costing disproportionately more than the loss which could be incurred by its failure is seen to be poor value for money.

Third, *almost any control can be corrupted, circumvented or ignored* in line with the limitations outlined in the first section of this answer. With sufficient determination, an employee or service user can act against a control. Similarly, a technical failure (such as loss of power or a computer failure) can render even the most well-designed control less effective.

(c) Continuing professional development (CPD) for Sonja Tan

The case mentions that Sonja Tan attended the CPD session on improving internal controls. This would have been a worthwhile and useful event for a professional accountant and/or company director, and one which fits with the general purposes of CPD.

The first advantage of CPD for Sonja Tan is to *maintain and update the currency of her skills and knowledge*. If she trained as an accountant some time ago, it is likely that changes to accounting procedures and local regulation have taken effect since she qualified. Whilst the knowledge gained during her training would have been sufficient in the early part of her career,

her continued effectiveness as a practitioner will be greatly assisted by her CPD. One of the five IFAC (IESBA) fundamental ethical principles is *professional competence and due care*. Mandatory CPD is an effective safeguard against any threats to this principle as far as an individual professional is concerned.

CPD can also *broaden Sonja's skills*. By learning about more general management and management control issues, such as internal controls, she is developing skills alongside her accounting expertise. By learning about, for example, technical computing issues, logistics and other issues relevant to her work situation, Sonja can become a more effective director, especially at a senior level such as FD where a good knowledge of the whole business is assumed.

As a profession, accounting enjoys the support of society and in return, professions such as accounting have to continually ensure that its members are *fit to serve society's needs*. The maintenance of skills and knowledge ensures that the accountant is seen to behave in the public interest and is able to continue to respond to the public need for the profession's skills. Maintaining the support and confidence of society is important for any profession (such as accounting, medicine, banking) and the maintenance of a CPD record is a good way to demonstrate this.

- 1** (a) 2 marks each for examination of the two claims.
2 marks for discussion of conflict.
1 mark for evidence of understanding of stakeholder claim (anywhere in answer). (7 marks)
- (b) 2 marks for explanation of corruption.
2 marks each for corruption at Cornflower to a maximum of 8 marks. Half mark for identification only. (10 marks)
- (c) 3 marks for each risk – one for definition and up to two for importance in context. (9 marks)
- (d) (i) 2 marks for explanation of citizenship in terms of rights and responsibilities.
2 marks for explaining each in terms of the case to a maximum of 4 marks. (6 marks)
- (ii) 1 mark each for explanations of accountability and fiduciary duty.
2 marks for each relevant point made on the relevance of each to Cheapkit from the pristine capitalist perspective. (6 marks)
- (iii) 2 marks for explanation of the basic framework of IR.
2 marks for each advantage explained to a maximum of 6 marks. (8 marks)
- Professional marks (4 marks)
- 2** (a) 1 mark for each explanation of Chambon as a public sector organisation to a maximum of 4 marks. Half mark for identification only.
2 marks for assessment against objectives to a maximum of 6 marks. (10 marks)
- (b) 1 mark for each role of governors to a maximum of 4 marks.
2 marks for each point on transparency to a maximum of 4 marks.
1 mark for evidence of understanding of transparency (anywhere in the answer). (9 marks)
- (c) 2 marks for each advantage to a maximum of 6 marks. (6 marks)
- 3** (a) Up to 2 marks for each role and quality to a maximum of 8 marks. Half mark for identification only.
1 mark for each point of unsuitability explained to a maximum of 4 marks. Half mark for identification only. (Maximum 10 marks)
- (b) 1 mark for each benefit of NEDs at NIC to a maximum of 3 marks.
Up to 2 marks for each difficulty in recruitment. (9 marks)
- (c) Up to 2 marks for explanation of conflict of interest.
Up to 2 marks for each relevant point made on Dr Idris's conflict of interest to a maximum of 4 marks. (6 marks)
- 4** (a) Up to 2 marks for each relevant argument. (10 marks)
- (b) 1 mark for each reason identified and explained to a maximum of 5 marks. Half mark for identification only.
2 marks for each relevant discussion point in relation to cost to a maximum of 6 marks. (Maximum 9 marks)
- (c) 2 marks for each relevant point made to a maximum of 6 marks. (6 marks)