Answers
1 (a) Related and correlated risks

Related risks are risks that vary because of the presence of another risk or where two risks have a common cause. This means when one risk increases, it has an effect on another risk and it is said that the two are related. Risk correlation is a particular example of related risk. Risks are positively correlated if the two risks are positively related in that one will fall with the reduction of the other, and increase with the rise of the other. They would be negatively correlated if one rose as the other fell.

Legal risk and reputation risk

At Hoppo, legal risk and reputation risk are likely to be positively correlated because it is likely that as legal risk rises, then, for the reasons explored below, so will reputation risk. Were the legal risk to recede, then risk of reputational damage would also recede. In the case of legal and reputation risks at Hoppo, legal risk is the independent variable and reputation risk is the dependent variable. This is because the reputation risk incurred will largely depend on the legal risk.

The legal risk in this case is the possibility that, if Red Co’s outsourced manufacturing contract is cancelled, Red Co will pursue a legal case against Hoppo. Because so many jobs (about 1,000) and a lot of future earnings for Red Co are at stake, Red Co may vigorously pursue the case and seek to gain damages for the loss of a valuable contract and employee termination costs. It is not certain that Red Co would take this option, though, and so the probability of this occurring is not known.

The reputation risk is the loss to Hoppo if issues were to be raised in the public consciousness that might cast the company in a negative light. It is hard to know in advance how a legal challenge would be reported but Hoppo could be accused, justly or unjustly, of several things. Legal cases sometimes raise issues in the public consciousness that the company would have otherwise not had exposed. Some of these may be perfectly legitimate in business terms but may offend one or more stakeholders.

In the case of Hoppo, they may be accused of incompetence in drawing up the outsourcing contract with Red Co. The fact that the legal agreement is considered by some to be ambiguous suggests incompetence and this may erode Hoppo’s reputation for competence. The loss of about 1,000 jobs at Red Co, arising from the loss of the Hoppo contract, is likely to be widely reported, particularly in Teeland. Although jobs are likely to be created in Yuland if the new facility is built there, some may interpret this re-location as a breach of good faith with Red Co and demonstrating a lack of business integrity on Hoppo’s part. The effect of any loss of reputation for Hoppo could be serious.

Hoppo may also be portrayed as an unreliable business partner and this may affect future outsourcing opportunities, especially where the other company is in another jurisdiction and legal complications may consequently arise. In addition, any loss of reputation is probably quite important for Hoppo, as the case makes clear that both customers and some key employees interact with the company partly based on its favourable social and environmental reputation. In that case, an eroded reputation may affect product sales and also recruitment.

(b) Description of environmental report

In most jurisdictions, the production of environmental information is voluntary in that it is not required by any accounting standard or legal statute. In some cases, environmental information is included in the regular annual report and in other cases, ‘stand alone’ environmental and/or sustainability reports are published, usually annually. Although these are often published as hard copy documents, they are also often made available on company websites.

In each case, however, the purpose of an environmental report is to report on some of the details of the company’s environmental impact or ‘footprint’. Because some of this information is technical in nature, systems need to be put in place to generate and internally assure the data, similar to those systems necessary for generating accurate financial data.

The contents of an environmental report typically include information on the company’s direct environmental impact (through its own manufacturing and distribution) and also its indirect impacts (through its forward and backward supply chains). It involves recording, measuring, analysing and reporting on the environmental impact, usually in respect of two aspects: consumption (of energy and other resources) and production. This latter impact (production) involves the measurement and reporting of the environmental impact of products and also any other emissions, such as by-products and any pollutants.

Advantages for Hoppo and its shareholders

The first advantage of environmental reporting would be to provide information to investors on the sources and ways of mitigating environmental risk, and of those risks correlated with environmental risk. The events at Red Co have the potential to damage Hoppo’s reputation and potentially turn some customers away from buying Hoppo products because of the implication that Hoppo has poor environmental controls in its supply chain.

Second, an environmental report would enable Hoppo to demonstrate its responsiveness to major issues such as the leakage of TY13 at Red Co. Likewise, it would be a suitable place to inform shareholders on the ‘state of the art’ environmental performance of its new factory in Yuland. Some customers are known to buy from Hoppo partly because of its environmental reputation, and some employees, similarly, are attracted for the same reason. These factors make this responsiveness potentially very important.

Third, the regular production of an environmental report would necessitate the establishment of measurement systems able to generate the information for the report. This would mean that the company would have greater knowledge of, and control over, its resource consumption, environmental efficiency and emissions. This knowledge could then, in turn, save costs and
improve internal controls in the company. In the case of a new-build facility in Yuland, systems for gathering this data can be ‘designed-in’ to ensure that information is meaningful, accurate and timely. These measures may help convince investors that Hoppo is a sound long-term and sustainable source of shareholder value.

Fourth, reporting strengthens the accountability to the shareholders and encourages better environmental performance as a result. Once a company reports on a policy, a measure or a target (for example), it provides something against which it can be later held to account. For shareholders, the publication of environmental information means that the company can be required to respond to queries on underperformance against agreed standards. This could serve, over time, to make the board more answerable to shareholders and reduce the agency gap.

(c) Strategic internal controls

Internal controls can be at the strategic or operational level. At the strategic level, controls are aimed at ensuring that the organisation ‘does the right things’; at the operational level, controls are aimed at ensuring that the organisation ‘does things right’. Those controls that operate at the strategic level are capable of influencing activities over a longer period. This concerns issues capable of affecting the strategic positioning of the organisation. In the case of Hoppo, the shortage of the supply of TY13 is capable of affecting its output and hence its ability to meet its strategic objectives in terms of the TY13-containing products. The overall objective of internal control is to ensure the orderly conduct of business and this requires effective controls from the top to the bottom of the organisation.

Internal controls in the Yuland factory

Internal controls apply to all processes and procedures within an organisation. For controls in an internal value chain for a manufacturer, effective internal controls are necessary to ensure the efficient adding of value to inputs and the minimisation of waste. In the case of working with TY13, however, the case describes several specific reasons that need to be taken into account. Red Co, having worked with TY13 for many years, has developed some competence in this, but evidently not entirely so, as evidenced by the leakage of TY13 from its plant in Teeland.

The first issue that makes internal controls over TY13 so important is its high cost and the fact that small inefficiencies can disproportionately affect final product costs and hence profitability. As a highly specialised material, TY13 is used in small quantities but any inaccuracies in application, or losses in the process, can affect the economics of the production process. This may affect the profitability of production in extreme cases.

Second, TY13 is highly toxic and so should be controlled internally (to prevent exposure to employees) and externally, to prevent leakage such as happened at Red Co. This is likely to be controlled by regulation in Essiland but the situation is unclear in Yuland. It is likely that stringent controls will be needed to minimise the chances of leakage or loss and this is not only an economic issue (protecting value) but also a social and environmental issue.

Third, there are general supply problems. TY13 is a rare material as highlighted by the report. This means that relationships with suppliers may become strategically important. The case indicates that Red Co had cultivated strong relationships with suppliers and a challenge for Hoppo would be to build up similar relationships, so that supply would be safeguarded if world shortages occur.

Fourth, because supply quality varies, the testing of TY13 at the ‘factory gate’ can be important in ensuring that the delivered material is fit for purpose. Because the performance of the finished product depends heavily on obtaining the required grade of TY13, control over this test is likely to be very important. Hoppo would need to have stringent material tests if this variability of supply quality is not to undermine the quality of its finished goods.

(d) (i) Press release

Hoppo Co is pleased to respond to allegations made in the media about the events surrounding recent discussions concerning its outsourcing activities. In seeking to protect Hoppo’s business and ethical reputation, it is true that we are considering the future of our links with one of our outsourcing partners. Hoppo was very disappointed to learn of the poor employee conditions at Red Co and also the leakage of TY13 into a local river. The company is considering options for the future to prevent such events from happening again. This includes the option of taking manufacturing under direct control.

We take this opportunity to inform the public and our shareholders about the importance we place upon the highest levels of integrity and transparency, and why we believe these to be of the utmost importance in corporate governance. We also wish to explain the circumstances around the demand for an irregular payment from an individual in Ootown and why Hoppo considers it wrong to consider paying this in pursuit of its business objectives.

Integrity at Hoppo

For the avoidance of doubt, Hoppo accepts and agrees with the IFAC definition of integrity as that which, ‘imposes an obligation… to be straightforward and honest in professional and business relationships. Integrity also implies fair dealing and truthfulness.’

Hoppo believes that integrity is steadfast adherence to strict ethical standards despite any other pressures to act otherwise. Integrity describes an ethical position of the highest standards of professionalism and probity. It is an underlying and underpinning principle of corporate governance and requires anybody representing shareholders to possess and exercise absolute integrity at all times. Hoppo unreservedly and unambiguously accepts this and the duty it places on the board of directors.
Transparency and Hoppo  
Hoppo regrets the perception that it lacked transparency in considering issues concerning its investment in Yuland. The company also wishes to re-emphasise its belief in the importance of transparency in matters of corporate governance. To Hoppo, transparency means providing open and clear disclosure of relevant information to shareholders and other stakeholders. Hoppo believes that it should not conceal information when it may materially affect others. It means open discussions and a default position of information provision rather than concealment. This means that when there is no good and legitimate reason to conceal discussions or other information, it should be disclosed as a matter of course. This has been, and remains, Hoppo's position.

(ii) The issue of the ‘personal gift’ (bribe)
Hoppo would like to publicly explain, to reassure our stakeholders and again for the avoidance of any doubt, why it believes that paying a bribe to the mayor of Ootown is wrong. This is despite the fact that, all other things being equal, Ootown was and remains an attractive location for the construction of the new factory. The board accepts that this is a serious issue relating directly to the integrity of the board and so a direct and detailed response is merited. As a company that believes in the highest standards of conduct in all business matters, Hoppo always seeks to apply best practice and, accordingly, believes it is never appropriate to consider paying bribes, whatever the circumstances.

First, there is a strong business case for rejecting this demand. It is very important that Hoppo is trusted by its shareholders and others. It is equally important that employees find Hoppo a good and ethical company to work for, and to invest their working lives with. In both cases, any suggestion of a lack of probity would be potentially very damaging and this may harm Hoppo’s goodwill and the quality of the relationship with its employees. Even though, all other things being equal, we believe that Ootown may be a very good option for the new factory, being exposed for paying a bribe would do long-term damage to the business.

More importantly, though, there is an overwhelming ethical case to reject the option to pay the bribe and to investigate the feasibility of using Ootown without doing this, or choosing Aatown.

[Tutorial note: This is the deontological perspective]
From one perspective, Hoppo believes that principles and duties are important in business. Businesses and individuals have an ethical duty to act with integrity and the highest standards of professionalism at all times. We believe that the world would be a poorer place and that business would be very badly affected if bribery became an acceptable and a normal part of business life. If everybody practised bribery in making business transactions, then this would undermine trust in business and make international business investments, like that in Yuland, almost impossible. Because it would, if generalised, have a negative set of outcomes, Hoppo believes it is unethical in principle. If it is wrong in general, then it cannot be right in specific cases.

[Tutorial note: This is the consequentialist perspective]
Hoppo also believes that paying the bribe is wrong in terms of achieving the outcomes that the company seeks. Were the company to pay the mayor of Ootown in order to facilitate the planning permission needed, a number of very unfortunate consequences might arise. First, Hoppo might gain a very unhelpful reputation in the region as a company that can be bribed, and this, in turn, would increase the possibility of repeat occurrences. Second, even if the payment were not discovered, it would mean that the threat of public disclosure would make Hoppo vulnerable to other demands from the mayor of Ootown.

We hope that this statement has addressed the concerns of all of our stakeholders.

2 (a) Introduction to internal audit
Internal audit is an independent appraisal function established within an organisation to examine and evaluate its activities as a service to that same organisation. The objective of internal audit is to assist members of the organisation in the effective discharge of their responsibilities. To this end, internal audit furnishes them with analyses, appraisals, recommendations, advice and information concerning the activities reviewed. The main functions of concern to internal audit are reviews of internal controls, risk management, compliance and value for money.

[Tutorial note: Evidence of understanding of IA may be anywhere in answer.]

Internal audit in regulated industries
Internal audit is generally considered to be more important in highly regulated industries (utilities, such as water or energy, and pharmaceuticals, defence equipment, etc) because there is a need, not only to deliver an internal service to aid organisational efficiency, but also to ensure compliance with externally-imposed requirements. These may involve a range of technical product compliance issues, product safety issues, hygiene issues, production facility issues or other, similar regulations. They may be legal in nature or may be enforced by an industry regulator at ‘arm’s length’ from government.

Where requirements are imposed by external regulation, the company must usually provide compliance information to that external regulator. This involves the establishment of systems for collecting and analysing that data, and also producing reports to demonstrate the levels of compliance. Because compliance information may not always report ‘good news’, it is important that the auditor is independent of those being audited and, for this reason, a formal internal audit function is usually more necessary in such circumstances.
In regulated industries, the assurance of compliance is a strategic asset and is somewhat more important than (merely) a desirable outcome. Compliance failure may mean that the company loses its licence to operate, or it may be subjected to punitive fines. In either case, it could be unable to continue to conduct normal business and so internal audit’s role is a key part of the company’s strategic success.

(b) Criticisms of Blup Co’s audit committee

There are three ways in which Blup Co’s audit committee fails against best practice criteria. First, it is likely that it is not sufficiently independent of the executive board, with its entire membership being retired executives. Some jurisdictions place a time limit (after retirement) before a former executive member can take up a non-executive director (NED) position. This is because of the likely lack of independence and objectivity that such a person would have.

Second, because the audit committee is required to monitor and review the company’s accounts and internal controls, it is often required that at least one member has recent, relevant financial experience (in Singapore, this requirement is more stringent). In Blup Co, all three members are water engineers. Although clearly an important area to understand in the case of Blup, this does not appear to provide the level of financial literacy that the committee needs to perform its roles.

Third, the audit committee has allowed, and possibly encouraged, the appointment and retention of an external auditor who appears to lack independence. The fact that the head of the external audit practice was a member of the chairman’s extended family could give the appearance of a lack of independence (even if not actually true) and is clearly a familiarity threat. Shareholders rely on external auditors to provide a rigorous and independent scrutiny of the company. The audit committee is responsible for recommending external auditor appointments to the board and in doing so, should ensure that there are no factors that might threaten their independence from the company being audited.

(ii) Audit committee overseeing internal audit

There are several reasons why internal audit is overseen by, and has a strong relationship with, the audit committee.

The first reason is to ensure that internal audit’s remit matches the compliance needs of the company. The internal audit function’s terms of reference are likely to be determined by strategic level objectives and the risks associated with them. The audit committee, being at the strategic level of the company, will frame these for implementation by the internal audit function.

Second, the audit committee will be able to ensure that the work of the internal audit function supports the achievement of the strategic objectives of the company. Whilst this applies to all functions of a business, the supervisory role that the audit committee has over the internal audit function means that this responsibility rests with the audit committee in the first instance.

Third, oversight by the audit committee provides the necessary authority for the internal audit function to operate effectively. This means that no-one in the company can refuse to co-operate with the internal audit function and that members of that function, whilst not being necessarily senior members of staff themselves, carry the delegated authority of the audit committee in undertaking their important work.

Fourth, by reporting to the audit committee, internal auditors are structurally independent from those being audited. Because they and their work is sanctioned and authorised by the audit committee, the IA function should have no material links with other departments of similar hierarchical level which might compromise independence.

(c) Effective internal controls in assuring the integrity of financial reporting

The integrity of financial reporting is an essential underpinning of sound corporate governance. Shareholders and others rely on this information for their own decision-making and in influencing their perceptions of the value of the company. Many corporate governance codes, in recognising this link, require the publication of a report on the effectiveness of controls over financial reporting. All of these can be made subject to internal audit review to ensure ongoing compliance. In some jurisdictions, the internal controls over reporting are made compulsory through such instruments as financial reporting standards.

Effective internal controls are necessary for several reasons. First, they are more likely to create systems capable of generating accurate and reliable information. A lack of IC systems may allow for subjective and ‘best guess’ figures to be fed into the reporting process, but a robust system of internal control, with specified ways of measuring and reporting, can minimise this. These systems also provide information systematically to include within financial reports.

Second, to identify specific people and functions responsible for operating a particular control. A robust IC system will not expect reporting information to ‘just happen’, but rather, a certain control and/or named person can be made accountable for the delivery of a specific input or set of inputs into the reporting process.

Third, to make the process visible and amenable to scrutiny by either internal or external auditors. By having a clear allocation of controls over each stage of the reporting process, an auditor can analyse the quality of control and the information it has produced, at any stage. Or, in the case of an error, the auditor can easily trace back to find how and where the error was introduced.
3 (a) **Explanation of risk assessment**

Risk assessment is the process of evaluating the importance of a risk by making an estimate of two variables: the probability of the risk event being realised and the impact that the risk would have if it were realised. Probability refers to the likelihood of the risk materialising and is expressed either as a percentage or as a proportion of one (e.g. a 0.5 risk is considered to be 50% likely). The impact refers to the value of the loss if the risk event were to materialise. The estimated values of these two variables can be plotted on a risk assessment ‘map’, where the two axes are impact and probability. Then, different risk management strategies can be assigned depending upon the area of the map the risk is plotted in.

Risks assessed at low probability and low impact can be accepted or tolerated, those with high impact but low probability are often transferred or shared, risks with low impact but high probability are typically reduced and those with high impact and high probability are typically avoided. Risks that are known to be more likely to occur in the near future (‘proximate’ risks) may be assessed as higher probability and have more urgent strategies applied for managing them.

**Continuous and ongoing**

The first reason why there needs to be a continuous and ongoing risk assessment is because of the strategic importance of many risks and because of the dynamic nature of those risks being assessed. Some risks reduce over time and others increase, depending upon changes in the business environment that organisations exist in. Accordingly, it should not be seen as a ‘once and for all’ activity. If there is a risk that companies who borrow money become less able to repay their loans than previously, this is a negative change in the business environment (thereby affecting liquidity risk). When business recovers and bank customers’ ability to repay large loans improves, the liquidity risk for the banks is reduced.

Second, it is necessary to always have accurately assessed risks because of the need to adjust risk management strategies accordingly. The probabilities of risk occurring and the impacts involved can change over time as environmental changes take effect. In choosing, for example, between accepting or reducing a risk, how that risk is managed will be very important. In reducing their lending, the banks have apparently decided to reduce their exposure to liquidity risk. This strategy could change to an ‘accept’ strategy when the economy recovers.

For BigBank, changes in the economic environment of Dubland mean that liquidity risks have increased. As business confidence rises and falls in Dubland, the probabilities and impacts of different risks will change. In this case, BigBank has decided that a reduction in lending is a suitable response to mitigate its financial risks, but this measure is likely to change as business confidence improves and, indeed, the finance minister has asked the banks to consider this.

(b) **Fiduciary duty**

A fiduciary duty is an often onerous duty of care and trust that one party owes to another, mainly defined in terms of a financial duty of care in a business context. It can be either a legal duty or a moral duty (or both). In the case of a legal duty, it is legally required, for example, for a solicitor to act in the best interests of a client, or a nurse to act in the best interests of a patient. In other situations, the legal responsibilities are more blurred but an ethical duty may remain. Many would argue, for example, that people owe a fiduciary duty to certain ancient monuments or to the preservation of a unique landscape.

The issue here is the fiduciary duty owed by Mr Ng, the chief executive of BigBank. In terms of his agency relationship with the BigBank shareholders, he is legally correct in his belief that he has a pre-eminence duty to the shareholders. The problem arises when the effects of his duty to the bank’s shareholders is taken into account and this raises a number of potential issues.

**Critical evaluation**

In support of his belief about his ‘only duty’ being to shareholders (a pristine capitalist perspective) is the fact that as an agent of the shareholders, he is employed by them and legally and morally bound to act primarily in their economic best interests. It will often be the case that one strategy favours one constituency (e.g. the shareholders) whilst disadvantaging another, but this does not warrant him adopting a course of action that would increase the bank’s risk exposure or reduce shareholders’ returns. Such an action would be a de facto theft of company value and hence very unethical. If he were to weaken the bank’s risk management in order to reduce the harmful effects on borrowers (and satisfy the finance minister’s requirements), he would not be acting in the best interests of the shareholders, who have every right to expect him to protect their interests over all other claims upon the bank.

Arguments against his remark arise from the belief that he is being naïve and shortsighted by suggesting that his only duty is to the shareholders. There are both strategic and ethical reasons why, in this case, assuming a narrow and short-term focus on shareholder value is wrong. The finance minister mentioned the importance of banks in wider society and the fact that the lack of lending has had negative effects on the Dubland economy. Not only might this be unfair to other businesses and individuals unable to gain loan capital, but it might have a longer term effect on BigBank itself, and its shareholders, if the economy shrinks and there is less demand for lending when the economy recovers.

(c) **Financial risks**

Financial risks are those arising from a range of financial measures. The main impacts of financial risk are on either cash flow or cost of capital (or sometimes both). They are so important to a business because of the extent to which cash flows facilitate normal business operations. When cash flows are insufficient to meet cash needs, they can create difficulties including, ultimately, the failure of the business.

The most common financial risks are those arising from financial structure (gearing), interest rate risk, liquidity, credit, cash flow and currency risks. High gearing can be a source of financial risk, when, for example, monetary pressure in the economy increases interest payments and causes reduced cash flows from the income statement. This is similar to interest rate risk, which concerns the company’s vulnerability to rising or falling interest rates (depending on whether the company relies on
the interest rate from borrowings or from bank deposits). Liquidity risks concern the ability of the business to meet short-term financing challenges, credit risk is the risk of not being paid on time (or at all) and currency risks are risks arising from adverse movements in exchange rates that might devalue the value of cash held in a given currency, make imported goods more expensive or exported goods less competitive.

**Embedding financial risk management**

Risk management becomes most effective when it is embedded into the company. This means that it is not a 'stand alone' activity but becomes normal behaviour. The value of managing and controlling the risk becomes widely accepted and made a part of many people's roles, as a part of their normal behaviour. In particular, embedding financial risk management can be achieved in BigBank by the use of several measures.

First, because financial risks are technical in nature (concerned with risks that might affect the company's cash flow), it may be necessary to inform and educate a wide range of employees to understand and recognise risk factors. This may also involve advising on the importance of financial risks by discussing the impacts they can have and hence the necessity of managing them. The extent of this education and information will depend upon the specific structure of the company and the levels of the business that are deemed to 'need to know'.

Second, technical accounting and monitoring systems need to be implemented that measure and report (to management) on agreed targets, measures and compliance with those. These might involve regular reports against key targets (perhaps monthly) and 'alerts' if one or more of the measures strays out of its specified range.

Third, human resource systems can be designed to provide incentives for monitoring and alerting management about the risks. Rather than encouraging risk taking in BigBank, staff appraisals and the reward structures could be designed to reward behaviour more likely to control and mitigate the financial risks.

Fourth, awareness of financial risks, and those things that can increase them, can be normalised as a part of BigBank's culture. This would mean that it became a normal thing to discuss, tell stories about, create rituals around, etc. In the same way that health and safety risks have become a part of the culture in many organisations, financial risks could be more firmly embedded by achieving this.

4 (a) **Codes of corporate governance**

A code (of corporate governance) is a document that specifies certain standards, principles, norms of behaviour or specific instructions over matters of corporate governance. Some have evolved over time as different previous reports were written for different aspects of governance, which were then brought together in combined codes. Others have borrowed from existing codes, perhaps amended slightly to account for national differences.

Codes of corporate governance are issued by regulatory authorities (such as stock exchanges, governments or semi-autonomous government bodies) and are statements of general principles and detailed guidelines on many matters of corporate governance. They can be implemented either as listing rules (in principles-based jurisdictions) or in law (in rules-based jurisdictions). They typically cover all relevant aspects of corporate governance including the roles of the board, risk management, internal controls, executive remuneration and contracts, reporting issues and similar relevant themes. The purpose is to ensure that companies are well-run and in line with shareholders' interests.

The purposes of such codes are as follows. First, they guide and specify behaviour in matters of governance, internal control and risk management with the objective that by complying with the code, corporate governance will be improved and enhanced. Second, they aim to encourage best practice and to improve management performance by preventing practice that might reduce value added or shareholder value.

Third, codes aim to underpin investor confidence in that high levels of compliance tend to be appreciated by shareholders and poor levels of compliance are sometimes punished. It enables boards to demonstrate the value they place upon the agency relationship and to more adequately discharge the agency responsibilities placed upon them. Fourth, codes aim to reduce fraud, waste or inefficiency. One of the main causes of the development of codes (for example in the UK and in the USA) was in response to high profile frauds, and it was hoped at the time that codes would address this.

Fifth, in principles-based jurisdictions, the implementation of codes is thought to be a way of reducing the chances of governmental legislation being implemented. Governments are more likely to legislate where other regulatory failure is evident and so an effective code applied as listing rules should (many hope and believe) reduce the likelihood of having inflexible laws applied.

(b) **Components of reward package**

Sarah Umm told the remuneration committee that the rewards should be linked strongly with the company’s strategy and that these strategic priorities were to ‘incentivise medium to long-term growth whilst retaining the existing executive board as long as possible.’

The retention of the existing board will be aided by providing a basic salary that meets market rate with in-kind benefits commensurate with the role. This is to ensure that the director is satisfied, and believes himself or herself to be fairly rewarded, regardless of performance in the role. Retention can be helped by the payment of one or more loyalty bonuses for staying more than an agreed time period. Again, these would be regardless of performance and intended solely to reward loyalty. These may not necessarily be monetary rewards. It may be, for example, that a director receives a car upgrade or additional days paid holiday after the agreed time period.
The incentivisation of medium to long-term performance will require the use of reward components such as performance bonuses and share options. Performance bonuses can be included for achieving certain targets in alignment with strategy. The dates on which these are paid can reflect the time-element of the incentivisation. Sarah Umm wants to incentivise medium to long-term performance, so this is likely to refer to years rather than months. In addition, the package could include share options which can be exercised after a number of years. These enable directors to benefit directly from increases in share value and because this is often a longer-term effect, share options may be designed to come into effect after, say, three years.

(c) General roles of non-executive directors (NEDs)

The four general roles of NEDs are: the strategy role, scrutinising role, risk role and the people role. In the strategy role, NEDs may challenge any aspect of strategy they see fit and offer advice or input to help to develop successful strategy. The scrutinising or performance role is where the NEDs’ independence is perhaps the most important. NEDs are required to hold executive colleagues to account for decisions taken and company performance. In this respect, they are required to represent the shareholders’ interests against any vested interests or short-term executive pressures.

The risk role involves NEDs ensuring the company has an adequate system of internal controls and systems of risk management in place. Finally, in the people role, NEDs oversee a range of responsibilities with regard to the management of the executive members of the board. This typically involves issues concerning appointments and remuneration, but might also involve contractual or disciplinary issues, and succession planning.

NEDs and performance-related elements

The main reason why NEDs are usually not allowed to receive share options or other performance-related elements as part of their reward packages (as Sam South asked) is because it could threaten their independence and hence their usefulness to the company’s shareholders. Whereas executive directors may, for example, be incentivised to take excessive risks to maximise their own rewards, a non-executive, without the performance-related element, will have no such incentive and will be likely to take a more objective view of the strategy being discussed.

In order to be effective in their roles, NEDs need to be motivated in different ways to their executive colleagues and too much similarity can mean that the scrutiny role is weakened. If both executive and non-executive directors are similarly motivated, there will be less scrutiny of proposed strategies for wider impacts, risks, complications and stakeholder impacts, because there will be no-one incentivised to exercise effective scrutiny.

If they received a similar mix of rewards to executives, they would be motivated to act in similar ways and this might involve favouring short-term measures at variance with longer-term strategic perspectives. A concern over short-term share price movements, for example, might take the NEDs' focus away from longer-term strategic issues and make them more concerned with maximising market value in the short term.

Because non-executives comprise the remuneration committee, it would be inappropriate for them to decide on their own rewards. It would be an abuse of the responsibility and trust invested in them by shareholders were NEDs to reward themselves too much or incentivise themselves in an inappropriate way. Accordingly, it is usual for NEDs to be paid a fair rate based on external comparison figures (often a daily rate or similar), so that there is no question of it being seen as excessive. A NED’s pay is usually a small fraction of that for executive colleagues.
1 (a) 1 mark for explaining related risks.
1 mark for explaining correlated risks.
1 mark each for evidence of understanding of legal and reputation risk.
1.5 marks for each issue explored from case exploring link between legal and reputation risk. Half mark for identification only.

(b) Up to 4 marks for description.
2 marks for each advantage.

(c) 2 marks for explaining strategic.
2 marks each for each IC explanation in context.

(d) (i) 1 mark for each relevant point explaining integrity in context to a maximum of 3 marks.
1 mark for each relevant point explaining transparency in context to a maximum of 3 marks.

(ii) 1 mark for each relevant point on the business case.
1 mark for each relevant point on deontological arguments (of which 1 for evidence of understanding).
1 mark for each relevant point on the consequentialist case (of which 1 for evidence of understanding).

Points may be made anywhere in the answer.

Professional marks for the format, tone, logical flow and persuasiveness of the press release.

2 (a) Up to 2 marks for explanation of internal audit anywhere in the answer.
2 marks for each point on regulated industry to a maximum of 6 marks.

(b) (i) 2 marks for each relevant criticism to a maximum of 6 marks.
(ii) 2 marks for each relevant issue of AC and IA to a maximum of 6 marks.

(c) 2 marks for each relevant discussion point.

3 (a) 1 mark for each relevant point on risk assessment to a maximum of 4 marks.
2 marks for each relevant point, in context, on the need for ‘ongoing’ to a maximum of 4 marks.

(b) 2 marks for description of fiduciary duty plus 1 mark for context of case.
1 mark for each relevant argument in favour of Ron Ng’s statement to a maximum of 2 marks.
1 mark for each relevant argument against Ron Ng’s statement to a maximum of 2 marks.

(c) Up to 4 marks for explanation of financial risks.
2 marks for each point about embedding risk at BigBank discussed.

4 (a) 2 marks for explanation (wherever made).
1 mark for each purpose discussed. Half mark for identification only.

(b) 2 marks for each relevant component discussed.

(c) 1 mark for each general NED role to a maximum of 4 marks.
2 marks for each problem with NEDs to a maximum of 6 marks.