First section

QUESTION (1) Compulsory:

Chemo is a well-established listed European chemical company involved in research into, and the production of, a range of chemicals used in industries such as agrochemicals, oil and gas, paint, plastics and building materials.

A strategic priority recognised by the Chemo board some time ago was to increase its international presence as a means of gaining international market share and servicing its increasingly geographically dispersed customer base.

The Chemo board, which operated as a unitary structure, identified JPX as a possible acquisition target because of its good product 'fit' with Chemo and the fact that its geographical coverage would significantly strengthen Chemo's internationalisation strategy. Based outside Europe in a region of growth in the chemical industry, JPX was seen by analysts as a good opportunity for Chemo, especially as JPX's recent flotation had provided potential access to a controlling shareholding through the regional stock market where JPX operated.

When the board of Chemo met to discuss the proposed acquisition of JPX, a number of issues were tabled for discussion. Bill White, Chemo's chief executive, had overseen the research process that had identified JPX as a potential acquisition target. He was driving the process and wanted the Chemo board of directors to approve the next move, which was to begin the valuation process with a view to making an offer to JPX's shareholders. Bill said that the strategic benefits of this acquisition were in increasing overseas market share and gaining economies of scale.

While Chemo was a public company, JPX had been family owned and operated for most of its thirty-five year history.
Seventy-five percent of the share capital was floated on its own country's stock exchange two years ago, but Leena Sharif, Chemo's company secretary suggested that the corporate governance requirements in JPX's country were not as rigorous as in many parts of the world. She also suggested that the family business culture was still present in JPX and pointed out that it operated a two-tier board with members of the family on the upper tier. At the last annual general meeting, observers noticed that the JPX board, mainly consisting of family members, had 'dominated discussions' and had discouraged the expression of views from the company's external shareholders. JPX had no non-executive directors and none of the board committee structure that many listed companies like Chemo had in place. Bill reported that although JPX's department heads were all directors, they were not invited to attend board meetings when strategy and management monitoring issues were being discussed. They were, he said, treated more like middle management by the upper tier of the JPX board and that important views may not be being heard when devising strategy. Leena suggested that these features made the JPX board's upper tier less externally accountable and less likely to take advice when making decisions. She said that board accountability was fundamental to public trust and that JPX's board might do well to recognise this, especially if the acquisition were to go ahead.

Chemo's finance director, Susan Brown advised caution over the whole acquisition proposal. She saw the proposal as being very risky. In addition to the uncertainties over exposure to foreign markets, she believed that Chemo would also have difficulties with integrating JPX into the Chemo culture and structure. While Chemo was fully

compliant with corporate governance best practice, the country in which JPX was based had few corporate governance requirements.

Manprit Randhawa, Chemo's operations director, asked Bill if he knew anything about JPX's risk exposure. Manprit suggested that the acquisition of JPX might expose Chemo to a number of risks that could not only affect the success of the proposed acquisition but also, potentially, Chemo itself. Bill replied that he would look at the risks in more detail if the Chemo board agreed to take the proposal forward to its next stage.

Finance director Susan Brown, had obtained the most recent annual report for JPX and highlighted what she considered to be an interesting, but unexplained, comment about 'negative local environmental impact' in its accounts. She asked chief executive Bill White if he could find out what the comment meant and whether JPX had any plans to make provision for any environmental impact. Bill White was able to report, based on his previous dealings with JPX, that it did not produce any voluntary environmental reporting. The Chemo board broadly supported the idea of environmental reporting although company secretary Leena Sharif recently told Bill White that she was unaware of the meaning of the terms 'environmental footprint' and 'environmental reporting' and so couldn't say whether she was supportive or not.

It was agreed, however, that relevant information on JPX's environmental performance and risk would be necessary if the acquisition went ahead.

Required:

(a) Evaluate JPX's current corporate governance arrangements and explain why they are likely to be considered inadequate by the Chemo board.

(10 marks)

(b) Manprit suggested that the acquisition of JPX might expose Chemo to a number of risks. Illustrating from the case as required, identify the risks that Chemo might incur in acquiring JPX and explain how risk can be assessed.

(15 marks)

(c) Construct the case for JPX adopting a unitary board structure after the proposed acquisition. Your answer should include an explanation of the advantages of unitary boards and a convincing case FOR the JPX board changing to a unitary structure.

(10 marks)

(Including 2 professional marks)

(d) Explain FOUR roles of non-executive directors (NEDs) and assess the specific contributions that NEDs could make to improve the governance of the JPX board.

(7 marks)

(e) Write a memo to Leena Sharif defining 'environmental footprint' and briefly explaining the importance of environmental reporting for JPX.

(8 marks)

(Including 2 professional marks)

(50 marks)

Second Section
Answer two questions only

QUESTION (2):

Mart plc is a medium sized retailer of fashion goods with some 200 outlets spread throughout the UK. A publicly quoted company on the London Stock Market, it has pursued a growth strategy based on the aggressive acquisition of a number of smaller retail groups. This growth has gone down well with shareholders, but a significant slowdown in retail sales has resulted in falling profits, dividends and, as a consequence, its share price.

Mart had been the creation of one man, Mr. Lord, a high profile entrepreneur, convinced that his unique experience of the retail business gained through a lifetime working in the sector was sufficient to guide the company through its current misfortunes.

His dominance of the company was secured through his role as both Chairman and Chief Executive of the company. His control of his board of directors was almost total and his style of management such that his decisions were rarely challenged at board level. He felt no need for any non-executive directors drawn from outside the company to be on the board. Shareholders were already asking questions on his exuberant lifestyle and lavish entertainment, at company expense, which regularly made the headlines in the popular press. Mr. Lord’s high profile personal life also was regularly exposed to public scrutiny and media attention.

As a result of the downturn in the company's fortunes some of his acquisitions have been looked at more closely and there are, as yet, unsubstantiated claims that Mart's share price had been maintained through premature disclosure of proposed acquisitions and evidence of insider trading. Lord had amassed a personal fortune through the acquisitions, share options and above average performance related bonuses, which had on occasion been questioned at the Shareholders' Annual General Meeting. His idiosyncratic and arrogant style of management had been associated with a reluctance to accept criticism from any quarter and to pay little attention to communicating with shareholders.

Recently, there has been concern expressed in the financial press that the auditors appointed by Mart, some 20 years ago, were also providing consultancy services on his acquisition strategy and on methods used to finance the deals.

Required:

(a) Explain the nature of the agency problem that exists in Mart.

(3 marks)

(b) Assess the extent to which Mart's corporate governance arrangements and situation fail to constitute governance best practice.

(12 marks)

(c) Mr. Lord has consistently resisted the appointment of independent, non-executive directors to the board of Mart plc. Construct a case for Mart appointing independent non-executive directors.

(10 marks)

(Total = 25 marks)

QUESTION (3):

The board of Global, a large manufacturing company, decided to set up an internal control and audit function. The proposal was to appoint an internal auditor at mid-management level and also to establish a board level internal audit committee made up mainly of non-executive directors.

The initiative to do so was driven by a recent period of rapid growth. The company had taken on many more activities as a result of growth in its product range. The board decided that the increased size and complexity of its operations created the need for greater control over internal activities and that an internal audit functions was a good way forward. The need was highlighted by a recent event where internal quality standards were not enforced, resulting in the stoppage of a production line for several hours. The production director angrily described the stoppage as 'entirely avoidable' and the finance director, Jason Kumas, said that the stoppage had been very costly.

Mr Kumas said that there were problems with internal control in a number of areas of the company's operations and that there was a great need for internal audit. He said that as the head of the company's accounting and finance function, the new internal auditor should report to him. The reasons for this, he said, were because as an accountant, he was already familiar with auditing procedure and the fact that he already had information on budgets and other 'control' information that the internal auditor would need.

It was decided that the new internal auditor needed to be a person of some experience and with enough personality not to be intimidated nor diverted by other department heads who might find the internal audits an inconvenience.

One debate the board had was whether it would be better to recruit to the position from inside or outside the company. A second argument was over the limits of authority that the internal auditor might be given. It was pointed out that while the board considered the role of internal audit to be very important, it didn't want it to interfere with the activities of other departments to the point where their operational effectiveness was reduced.

Required:

(a) **Explain, with reference to the case, the factors that are typically considered when deciding to establish internal audit in an organisation.**

(10 marks)

(b) **Construct the argument in favour of appointing the new internal auditor from outside the company rather than promoting internally.**

(6 marks)

(c) **Critically evaluate Mr Kumas's belief that the internal auditor should report to him as finance director.**

(4 marks)

(d) **Define 'objectivity' and describe characteristics that might demonstrate an internal auditor's professional objectivity.**

(5 marks)

(Total = 25 marks)

QUESTION (4):

When a prominent football club, whose shares were listed, announced that it was to build a new stadium on land near to its old stadium, opinion was divided. Many of the club's fans thought it a good idea because it would be more comfortable for them when watching games. A number of problems arose, however, when it was pointed out that the construction of the new stadium and its car parking would have a number of local implications. The local government authority said that building the stadium would involve diverting roads and changing local traffic flow, but that it would grant permission to build the stadium if those issues could be successfully addressed. A number of nearby residents complained that the new stadium would be too near their homes and that it would destroy the view from their gardens. Helen Yusri, who spoke on behalf of the local residents, said that the residents would fight the planning application through legal means if necessary. A nearby local inner-city wildlife reservation centre said that the stadium's construction might impact on local water levels and therefore upset the delicate balance of animals and plants in the wildlife centre. A local school, whose pupils often visited the wildlife centre, joined in the opposition, saying that whilst the school supported the building of a new stadium in principle, it had concerns about disruption to the wildlife centre.

The football club's board was alarmed by the opposition to its planned new stadium as it had assumed that it would be welcomed because the club had always considered itself a part of the local community. The club chairman said that he wanted to maintain good relations with all local people if possible, but at the same time he owed it to the fans and the club's investors to proceed with the building of the new stadium despite local concerns.

Required:

(a) Define 'stakeholder' and explain the importance of identifying all the stakeholders in the stadium project.

(10 marks)

(b) Compare and contrast Gray, Owen and Adams's 'pristine capitalist' position with the 'social contractarian' position. Explain how these positions would affect responses to stakeholder concerns in the new stadium project.

(8 marks)

(c) Explain what 'fiduciary responsibility' means and construct the case for broadening the football club board's fiduciary responsibility in this case.

(7 marks)

(Total = 25 marks)

'End of question'