SHADES OF GREY: DIRECTORS' DILEMMAS

Niamh M. Brennan

THE POWER OF ONE

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by

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Published by

ICAS

CA House 21 Haymarket Yards Edinburgh EH12 5BH

First published 2016

ISBN 978-1-909883-09-3
EAN 9781909883093

This report is published for the Research Committee of ICAS.

The views expressed in this report are those of the author and do not necessarily represent the views of the Council of ICAS or the Research Committee.

Printed and bound in Great Britain by TJ International

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FOREWORD

ICAS recognises the power of every individual CA – 'the Power of One' – to influence those around them.

Ethics and integrity are at the heart of the professional responsibilities of ICAS members. Through their ethical behaviour, CAs are a force for good in the organisations in which they work. They can also influence those around them, and thereby help shape the culture and values of their organisation. The cumulative effect of their influence can help reinforce the importance of ethics at the core of business practices and of a more responsible and holistic approach to business. In this way, CAs are a key component of building public trust in business to the benefit of our broader society. The call of ICAS is for every CA to place ethical leadership at the heart of their professional responsibilities, so as to shape the culture and values of their organisations, to help re-establish ethics at the core of business practices and to rebuild public trust in business.

This report by Professor Niamh Brennan links closely with that theme through analysing 34 ethical dilemmas covering six areas commonly experienced by company directors. The dilemmas cover areas of particular challenge in boardrooms, including directors' fiduciary duties/conflict of interest, the exercise of due care and skill, decision making, behavioural issues, information asymmetry and the conduct of board business. The primary aim of the report is for the dilemmas to be used for discussion and debate, led by an expert on the workings of boards of directors, either in a classroom/training setting or in a business setting.

The ethical dilemmas encountered in business are often complex and stressful, and the dilemmas analysed in this report raise issues common to boards across the globe. Although reference is made to a UK regulatory context, including the UK Corporate Governance Code, many of the regulatory principles are applicable in other jurisdictions. The dilemmas could therefore easily be used outside the UK by tailoring the context and discussion accordingly, thus helping to embed ethical values and thinking into the day-to-day work of company directors wherever they may be based.

The Research Committee of ICAS has been pleased to support this publication. The Committee recognises that the views expressed do not necessarily represent those of ICAS itself, but hopes that the dilemmas will be a useful training tool and a topic for debate and discussion.

Allister Wilson
Convener of ICAS Research Committee
March 2016

ACKNOWLEDGEMENTS

My sources for the dilemmas in this report comprise newspaper articles, personal sources and my MBA and Diploma in Corporate Governance students at University College Dublin. I piloted the dilemmas in my corporate governance classes. These class discussions were invaluable for refining the material and for preparing the analysis of each case. I thank my many super-smart students for their enthusiastic, helpful and challenging inputs. They are a joy to teach. I have learned so much from them. I thank Fergus Sheridan for Donna's Dilemma (Dilemma 5). I particularly thank Anne McFarland who took the trouble to forensically read the material and provide robust critical-friend feedback. I also benefited from materials generously shared with me by my colleague, Mr Pierce Kent.

I am grateful to the anonymous academic referee, the anonymous practitioner referee, and the previous ICAS research advisor, Professor Angus Duff, for their constructive and insightful comments, which led to a significant revision and improvement of the work.

I also thank ICAS staff for their support of this project, helping me to bring it to final publication: Michelle Cricket, Director of Research, James Barbour, Director of Technical Policy, and Angie Wilkie, Research Co-ordinator.

Finally, I am grateful for the hospitality of the Rotman School of Management, University of Toronto, for a visiting professorship in 2014 that provided the scholarly and extremely conducive environment to enable me complete this work. This was generously facilitated by a compression-of-teaching leave of absence in Semester 2, 2014 by the School of Business, University College Dublin.

1. INTRODUCTION

This report builds on the work of the ICAS's Ethics Committee in *Shades of Grey: Ethical Dilemmas,* which dealt with ethical dilemmas facing professional accountants. It was preceded by David Molyneaux's 2008 ICAS research report, *What do you do now? Ethical Issues Encountered by Chartered Accountants*. His report comprises 28 ethical dilemmas faced by chartered accountants. David was to have written *Shades of Grey: Ethical Dilemmas* but sadly passed away before that project commenced.

Following a similar style, this report addresses dilemmas facing company directors.

What is a dilemma?

Company directing is an art not a science. The directors' dilemmas attempt to capture the judgemental and subjective nature of company directing and what it is like being a director in practice. Dilemmas involve people having to make difficult or awkward decisions. A dilemma has been defined as a 'choice between two (or, loosely, more) alternatives either of which is (or appears) equally unfavourable'.[1]

The dilemmas have been designed so that they address serious issues that could arise for boards of directors, while at the same time making them entertaining so that in a classroom/training situation they might engender a lively discussion and even a bit of fun. Humour can be a potent pedagogic tool.

The dilemmas in this report

There are 34 dilemmas covering six areas commonly experienced by directors:

- Directors' duties – fiduciary duties/conflict of interest (7 dilemmas)
- Directors' duties – duties of care and skill (2 dilemmas)
- Decision making (10 dilemmas)
- Behavioural issues (4 dilemmas)
- Information asymmetry (4 dilemmas)
- Conduct of board business (7 dilemmas)

The first two areas – directors' fiduciary duties and duties of care and skill – derive from two key directors' common law duties. These regulatory requirements are discussed in Chapter 2 by reference to UK company law and a variety of common law cases. However, the dilemmas are broad, and are likely therefore to have wider global relevance beyond a UK audience and to be useful to company directors and those from any country interested in how boards work.

A central role of directors/boards of directors is to take decisions in order to direct their companies. This leads to the third area – decision making. The dilemmas in this section are quite mixed. In some cases, it could be argued that the dilemma could fit well in another of the six areas in the report.

In the conduct of boards, there is a great deal of talk about behavioural issues (captured by the oft-used word 'group think' in connection with boards). The fourth area addresses this difficult subject. Central to effective corporate governance is the sharing of information between all parties with governance roles, but most especially between executive and non-executive directors. The term 'information asymmetry' is used where one party has more/less information than another party and this subject is the fifth area considered.

The concluding sixth topic area relates to how boards conduct their business, which is critical to boards being effective. Guidance from the UK Financial Reporting Council (FRC) and from other sources is discussed in Chapter 2 in considering these issues.

Corporate governance varies depending on company type. A variety of company types feature in the dilemmas, including publicly listed companies, family businesses, subsidiaries, not-for-profit companies, publicly owned companies and public bodies. Thus, the dilemmas capture some of the unique features of these company types that can influence corporate governance.

Corporate governance also varies by country. There are different models of corporate governance, including the US rules-based model, the UK principles-based model, the continental European two-tier model of boards of directors, the Japanese business network model, the Asian family-based model and many others. International corporate governance research has identified systematic cross-country differences in the extent to which countries offer legal protection to minority shareholders, related to the extent to which investors are legally protected from expropriation by managers and controlling shareholders. The proportion of funding provided to companies by shareholders and debt holders varies. For example, in the US/UK capital is raised in capital markets versus Germany where banks provide most capital to companies. The financing of companies – shareholder orientation (US/UK) versus debt holder orientation (Germany) – influences their governance. Notwithstanding these jurisdictional differences, the dilemmas in this report will resonate with directors from many countries. However, discussion of the implications of each dilemma will vary depending on the detailed regulations applicable and international cultural differences, for example, influencing risk appetite which in turn influences how people approach decision making.

The terms 'managing director' and 'finance director', rather than Chief Executive Officer (CEO) and Chief Financial Officer (CFO), are generally used in the dilemmas to make it clear that the person is a director as well as an executive in the company.

Analysis of the dilemmas

Each dilemma is accompanied by a short analysis. The purpose of the analysis is to sensitise readers to the issues at play in the dilemma.

There is no right answer to the dilemma although there may be some courses of action that are clearly wrong. The dilemmas are deliberately designed to capture the grey areas in the real world, and to illustrate just how difficult it can be to be a good company director. That said, while there are lots of shades of grey, good company directors need to call black 'black' when it is so. It is important that directors stand up and say when certain behaviour is wrong. Particularly in a boardroom scenario, if you believe something is 'black' but do not say so, then you risk losing the opportunity for it to be explained. The issue may turn out to be more complicated than at first glance.

In analysing the dilemmas, the following analytical framework is adopted:

- The analysis of each dilemma commences with a series of questions for readers to consider.
- This is followed by headings under which a course of action could be formulated, including:
    - o Identification of key parties to the dilemma.
    - o Legal regulations to be considered and any pertinent associated case law.
    - o Guidance from codes of best practice such as *The UK Corporate Governance Code*.[2]
    - o Application of ethical principles, such as those outlined in the ICAS Code of Ethics.
    - o Other considerations.

Audience for the dilemmas

The anticipated audience for the report is broad: current and prospective company directors wanting to explore their responsibilities, directors and governors who may have encountered an ethical dilemma, those interested in governance, experienced professionals studying at executive education level, and less experienced undergraduate, postgraduate and professional accounting and law students who wish to better understand the complexities of the boardroom, together with educators wanting to use realistic case studies on ethics/corporate governance courses. The dilemma raise issues common to many boards. For this reason, they are likely to have global application. Their discussion may need to be tailored to the regulations and corporate culture in individual jurisdictions.

How to use the dilemmas

The primary intention is for the dilemmas to be used for discussion and debate, led by an expert on the workings of boards of directors, either in a classroom/training setting or in a business setting. Its value is in the discussion and debate the dilemmas prompt. An effective leader will enhance the quality of that discussion and debate. The dilemmas may also be useful to individual boards/organisations, for example, as part of an agenda for an away-day style meeting. It could reveal things that may be of benefit to an organisation. However, some readers may consider the dilemmas on their own, and the analysis of each dilemma is therefore written in such a manner that supports the individual reader in understanding the nuances of each dilemma.

Readers who wish to debate any of the dilemmas can contact the author by email (Niamh.Brennan@ucd.ie).

2. LEGAL, REGULATORY AND BOARDROOM CONTEXT

This chapter sets out some legal, regulatory and boardroom context for readers, to assist in understanding and addressing issues raised in the directors' dilemmas. The chapter is purposely short, therefore topics are addressed concisely and that coverage of each topic is therefore not exhaustive. While UK regulations are addressed in the chapter, the regulatory principles are applicable in most common law jurisdictions. Therefore much of what is stated is applicable in other countries.

The chapter commences by considering directors' duties, and discusses four regulatory sources of 'hard' law/'soft' law (i.e., not legally binding or only weakly legally binding) regulatory sources. Dilemmas 1-7 and 8-9 deal with the implications of these regulatory issues. This is followed by some guidelines on decision making and the exercise of judgement in boardrooms (captured by Dilemmas 10-19). The chapter concludes by addressing the key influence of behavioural issues (captured by Dilemmas 20-23), the pervasive risk of information asymmetry (captured by Dilemmas 24-27) and the importance of the conduct of board business (captured by Dilemmas 28-34).

Directors' duties (Dilemmas 1-9 and throughout)

By law, all incorporated companies must have directors, who together comprise the board of directors.[3] There are few legal requirements concerning the qualifications for directors. Thus, almost anyone can be a company director. Those ineligible include persons under 18 years of age, undischarged bankrupts, bodies corporate, those disqualified or restricted by the courts from being directors and the company's external auditor. Directors are appointed by the owners of companies, called shareholders or members, at company meetings, usually the annual general meeting. Directors must comply with the constitution of the company, i.e., the memorandum and articles of association, and with legal regulations but otherwise have a fairly free hand to use their judgement to conduct the business in the best interests of the company.

A distinction is often drawn between directors who work on a day-to-day basis in the company – executive directors – and those who attend board and governance-related meetings only – non-executive directors. This distinction has no basis in law. All directors are subject to the same legal duties. That said, ultimately, if the business fails, the managing director may in practice be held more responsible than the non-executive directors.

Duties of directors are set out in a variety of regulatory sources, including:

- statute (parliament-made law);
- common law (precedents set out in case law, i.e., judge-made law);
- self-regulatory codes of practice; and
- professional codes of practice.

Directors' statutory duties

Statutory regulations applying to company directors in the UK are mainly contained in the companies acts, although other legislation such as competition law, employment law, health and safety law, environmental legislation, also contain statutory duties for directors.

The UK Companies Act 2006 codified directors' common law duties into statute as follows:

- Section 171: Duty to act within powers.
- Section 172: Duty to promote the success of the company.
- Section 173: Duty to exercise independent judgement.
- Section 174: Duty to exercise reasonable care, skill and diligence.
- Section 175: Duty to avoid conflicts of interest.
- Section 176: Duty not to accept benefits from third parties.
- Section 177: Duty to declare interest in proposed transaction or arrangement.

Two long-standing common law directors' duties – fiduciary duty and duty of care and skill – were codified in sections 172 to 177 of the Companies Act 2006, together with a number of statutory duties, including the statutory requirement under Section 171 that directors act within their powers. Section 172 states: 'A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole'. The phrase 'in the way he considers' captures the judgemental element of being a director. Many of the dilemmas in this report are about the exercise of judgement rather than black or white, right or wrong, issues.

Included in Section 172 and the requirement to promote the success of the company are six, what are called 'enlightened', shareholder value factors:

- Likely consequences of any decision in the long-term.
- Interests of the company's employees.
- Need to foster the company's business relationships with customers, suppliers and others.
- Impact of the company's operations on the community and the environment.
- Desirability of the company maintaining a reputation for high standards of business conduct.
- Need to act fairly as between members of the company.

Directors' common law duties (now incorporated in statute in the Companies Act 2006)

Some dilemmas experienced by directors relate to issues likely to arise in common law. Common law duties of directors are contained in judge-made case law in the courts. It is not possible for statutes and/or self-regulatory codes of practice to anticipate every event in the boardroom. Case law and judgements of the courts result from dilemmas in which directors found themselves and chose to go to court (or were taken to court) to resolve. Two common law duties are especially relevant to how directors conduct themselves in the boardroom: Fiduciary duties of directors and the duty of care and skill.

Breaches of common law requirements (judge-made law) are enforced in the courts.

The common law standards for directors are low, although the bar is being raised by the courts all the time (see Brennan[4] for a description of two court cases, one decided in Australia in 2011 and one decided in New Zealand by the District Court in 2010 and by the Supreme Court in 2014, for an account of the standards being applied by common law courts to directors).

The law favours less competent directors. Such directors are more likely to be relieved of responsibility by the courts on the grounds of lack of knowledge or experience. If shareholders appoint directors who are not competent, or who do not have the knowledge, the company/its shareholders must bear the consequences of their own actions. Common law/the courts will hold directors of professional bodies, such as chartered accountants, to a higher standard than those not professionally qualified.

To whom do directors owe their duty? There is a number of possibilities here, including the company, shareholders, creditors and employees/other stakeholders. The particular circumstances of the company may influence the response to this question. Duties to creditors become more important when a company is in a financially stressed condition where solvency/survival is at issue.

An often-quoted extract from case law states: 'Directors have but one master, the company'.[5] As a result of this principle, only the company can sue a director for breach of duty. The general duty to the company is a corollary to the legal principle that a company is, in the eyes of the law, a separate person. In law, directors are agents of the company, not the shareholders. In a more recent case, Cullen, L.J. set out the legal reasoning for this principle:

> *It is well recognised that directors owe fiduciary duties to the company … These fiduciary duties spring from the relationship of directors to the company, of which they are its agents … I see no good reason why it should be supposed that directors are, in general, under a fiduciary duty to the shareholders, and in particular current shareholders with respect to the disposal of their shares in the most advantageous way. The directors are not normally the agents of the current shareholders … What is in the interests of the current shareholders … may not necessarily coincide with what is in the interests of the company. The creation of parallel duties could lead to conflict. Directors have but one master, the company.*[6]

Some case law, involving small more closely held private companies, has departed from this principle taking into account the particular facts of the case. Directors have been found in certain circumstances to owe a duty to shareholders, rather than the company.[7]

Section 172(1) of the Companies Act 2006 adopts a more shareholder-orientated perspective when it states that directors must promote the success of the company, using the phrase 'for the benefit of its members as a whole'. Thus, directors owe their duty to the company as represented by the shareholders as a group, not to individual shareholders or classes of shareholders.

Directors owe their duties first to the company in the form of 'members as a whole', and then to stakeholders, of which two groups are mentioned in company law: creditors and employees. When a company is 'nearing' insolvency, the duty to the company/members as a whole is effectively transposed into a duty to act in the interests of the company's creditors. Section 172(3) of the Companies Act 2006, requires directors 'in certain circumstances' to act in the interests of creditors. A clear understanding of the phrase 'in certain circumstances' is critical in directors knowing when they owe their duty to the company/members as a whole versus to creditors. There is ample case law confirming the requirement for directors to act in the interests of creditors over shareholders.[8] The explanatory memorandum to the Companies Act 2006 indicates that is it left to the courts to interpret the application of Section 172(3). The difficulty is in determining whether the company is insolvent at a point in time. Keay (2012)[9] discusses a range of possibilities: nearing insolvency, on the borderline of insolvency, on the verge of insolvency, doubtful solvency, risk of insolvency, dangerous financial state, parlous financial state, financially unstable and financial difficulties. This range illustrates just how difficult interpretation of this legal provision can be.

As referred to earlier, in relation to the six enlightened shareholder value factors, directors also have a statutory duty (Section 172 Companies Act, 2006) to have regard to the interests of employees, which was also a feature of the Companies Act 1985. Directors' duties to employee interests and to the company may occasionally be in conflict. As directors' duties to employees are owed to the company/members as a whole, in circumstances of conflict, directors' duties to employee interests are likely to be subsidiary to their duties to the company/members as a whole.

The business of the company is managed by the directors. Until the Companies Act 2006, directors' duties were expressed mainly in common law, with some specific statutory duties expressed in statute law. The duties of directors derive from the law of equity. Directors are trustees, acting in a fiduciary capacity to (ultimately) look after the best interests of the shareholders. The courts apply two broad principles against which to assess the conduct of directors:

- Act honestly, loyally and in good faith in the best interests of the company (Fiduciary duty).[10]
- Exercise due care and skill in managing affairs of the company (Duty of care and skill).[11]

Sections 175 to 177 of the Companies Act 2006 address the common law requirement of directors acting bona fide in the best interests of the company rather than in their own personal interests.

Fiduciary duty/conflict of interest

Directors are in a position of power in their management of a company, and are in a position to divert company resources to themselves at the expense of shareholders. Directors are in a fiduciary relationship – they are in a position of trust (fiduciary) and should act to the benefit of the company and in turn the shareholders (beneficiaries). This duty imposes a trustee responsibility on directors to take proper care of the company's assets.

Fiduciary duty is a duty to act honestly and *bona fide* (in good faith) (sometimes referred to as a duty of loyalty) and specifically addresses situations of conflict of interest. Insiders should not profit at the expense of the company. Directors should not make opportunistic personal profit from their positions as directors. Directors must not compete with the company. For example, directors cannot be in conflict with the company in relation to the use of company property, the use of knowledge acquired, the award of dividends or the purchase of assets of the company without due process.

Directors must disclose any interests that could be in conflict with the company's interests. Any transactions between directors and the company should be, and should be seen to be, at arm's length.

Following this principle, there are extensive 'related party' disclosure requirements concerning directors' transactions with the company, for example, remuneration, loans, guarantees and quasi-loans, share dealing and insider information.

Breach of fiduciary duty exposes a director to liabilities, and damages will arise where the interests of the company have been adversely affected. The test is subjective. Courts will interfere only if a reasonable director could possibly have concluded that a particular transaction was not in the best interests of the company. Directors can be in breach of their fiduciary duties without any conscious dishonesty on their part. To be regarded as acting *bona fide*, directors may have to balance the different interests of the company, and of different classes of present and future shareholders.

This common law duty has been codified in Section 175 of the Companies Act 2006 as follows:

(1) A director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company.

(2) This applies in particular to the exploitation of any property, information or opportunity (and it is immaterial whether the company could take advantage of the property, information or opportunity).

(3) This duty does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company.

(4) This duty is not infringed:

(a) if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest; or
(b) if the matter has been authorised by the directors.

(5) Authorisation may be given by the directors:

(a) where the company is a private company and nothing in the company's constitution invalidates such authorisation, by the matter being proposed to and authorised by the directors; or
(b) where the company is a public company and its constitution includes provision enabling the directors to authorise the matter, by the matter being proposed to and authorised by them in accordance with the constitution.

(6) The authorisation is effective only if:

(a) any requirement as to the quorum at the meeting at which the matter is considered is met without counting the director in question or any other interested director, and
(b) the matter was agreed to without their voting or would have been agreed to if their votes had not been counted.

(7) Any reference in this section to a conflict of interest includes a conflict of interest and duty and a conflict of duties.

Duty of care and skill

This duty requires directors to act in a reasonable, prudent, rational way, as expected of a similar person in her position. Directors are required to exercise care, skill and diligence. Not only are they are required to act honestly (fiduciary duty), but they are also required to act with skill and diligence. They are required to exercise reasonable care.

The duty of care and skill is subject to three principal qualifications:

- There is no requirement for a greater degree of skill than may reasonably be expected from a person of the director's knowledge and experience (thus the reference earlier to higher standards applied by the court to directors with greater qualifications such as chartered accountants).
- There is no need to give continuous attention to the affairs of the company. The phrase 'continuous attention' requires interpretation. The word 'maintain' is key in the observations of Parker, J. in the Barings case. He says that directors need 'to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors'.[12] While a director is not bound to give continuous attention to the affairs of the company he is expected to attend board meetings with 'reasonable' regularity.[13]
- Directors are entitled to rely on persons to whom business has been delegated (but see Brennan 2011[14] for the limitations of this qualification). Directors can delegate tasks to others but they cannot delegate their responsibility for the proper execution of those tasks. Further, if directors delegate to others, they must only delegate to persons with integrity and who have the skills and competencies for the task.

The duty of care and skill is a subjective measure. The courts are raising the bar all the time. Factors courts take into account include: facts and circumstances of the case, the company; the personal skills of individual directors. The principle applied by the courts is: 'A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience'.[15] Thus, as mentioned earlier, the law favours less competent directors if shareholders choose to appoint as their representatives those with lesser qualifications. Professional accountants fall into the category of expert directors. The level of expertise expected may depend on directors' roles. For example, a finance director may be expected to have higher expertise in relation to company financial statements than non-executive director colleagues. The higher duty of care and skill required of professional accountants compared with less qualified directors has been addressed in a number of cases.[16] The standard to be achieved by a professional is likely to be judged by reference to the opinions of other professionals acting as expert witnesses to the court. Accounting expert witnesses are likely to reference the standards of the relevant professional body, such as the ICAS Code of Ethics.

Failure to exercise such care amounts to negligence in common law countries.

Courts apply the 'business judgement rule' (when conflicts of interest are absent), which provides directors with the benefit of the doubt when things go wrong. Case law also suggests that directors cannot be held responsible for errors of judgement – the law does not expect infallibility from directors. In the words of the leading judgement, provided directors take adequate care and skill: 'It is perhaps only another way of stating the same proposition to say that directors are not liable for mere errors of judgement'.[17]

There is a general perception that the law treats executive and non-executive directors similarly, notwithstanding the information asymmetry between them. Company law does not distinguish between executive and non-executive directors. All directors have the same legal duties and obligations. However, common law is less clear on the similarities and differences between executive and non-executive directors. In restricting the non-executive director of an insolvent company, the fact the director was a non-executive director as opposed to an executive director was 'neither here nor there. He was a director and as such shares the responsibility to ensure that all is in order'.[18] Following this judgement, whether a board member assumes a non-executive role or delegates the management of the company to executives does not, and should not, lessen the directors' collective accountability for the management of the company. However, the case law extracts below indicate that some judges distinguish between types of director, with Peart, J. expecting a higher standard from non-executive directors of smaller than larger companies, and Hardiman, J. questioning whether the common law duties of a non-executive director appointed for a specific purpose can be assumed to be identical to those of executive directors.

> *... in a company where there are but two directors, the obligation on the non-executive director is even higher than a non-executive director of a larger company who may have certain identifiable and particular responsibilities within the company, but who may rely on other directors to carry out their particular functions, even though he would be remiss not to be concerned and satisfied as a member of the board of directors that all the affairs of the company were being properly attended to.*[19]

> *... there is a yet unmet need to make authoritative findings after full debate, as to the respective duties of an executive and non-executive director, and perhaps, a non-executive director appointed ... for a particular and specific purpose ... I would not be prepared simply to apply the Barings' criteria ... without such argument, to all these classes of director, or to assume that their common law duties are identical. I am slightly uneasy that, in this case, there may have been an assimilation in particular of the position of a non-executive director to that of an executive one.*[20]

Fiduciary duty is generally considered to be more onerous than the duty of care and skill. Fiduciary duty under the law of equity (i.e., for fairness in the legal system) requires a higher standard of behavior than the comparable duty of care and skill under tort law (the law relating to wrongdoing). Fiduciary duty entails twin objectives: of preventing undisclosed conflicts of duty and conflicts of interest, and of prohibiting the misuse of fiduciary positions.[21]

Self-regulatory codes of practice

There are a variety of self-regulatory codes of practice operating in different sectors of the economy, either required by regulators such as stock exchanges/government or industry/sectoral codes adopted voluntarily by companies. The UK Corporate Governance Code comprises main principles, supporting principles and more detailed code provisions. The Code operates on what is called a comply-or-explain basis. Companies must comply with the provisions of the Code or must explain non-compliance. Thus, non-compliance with the Code is not a breach of the Code provided non-compliance is explained. There is little or no regulatory oversight of the comply-or-explain system, thus the Code is referred to as 'self-regulatory'. These self-regulatory codes of practice deal with the conduct of board business in much more detail than statutory regulations or than case law under the common law system.

Professional codes of practice

All professions, including the accountancy profession, have their own internal codes of practice to which members of the profession undertake to adhere. Breach of professional codes of practice may lead to disciplinary action by the relevant professional body. For the purpose of this report, I have relied on the 2014 ICAS *Code of Ethics*[22], which is based on the Code of Ethics for Professional Accountants of the International Federation of Accountants (IFAC).[23]

The ICAS *Code of Ethics* applies to professional accountants in public practice and to professional accountants in business. The latter include salaried employees, executive directors, non-executive directors, owner-managers or volunteers. The Code indicates that the legal form of the relationship between the organisation and the individual has no bearing on the ethical responsibilities of the professional accountant in business. The Code applies regardless of whether the individual is being rewarded for the position held.

The ICAS *Code of Ethics* contains five fundamental principles, all of which are relevant to accountants holding directorships. These are:

- Integrity: to be straightforward and honest in all professional and business relationships.
- Objectivity: to not allow bias, conflict of interest or undue influence of others to override professional or business judgements.
- Professional competence and due care: to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.
- Confidentiality: to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.
- Professional behaviour: to comply with relevant laws and regulations and avoid any action that discredits the profession.

The ICAS *Code of Ethics* contains guidance on the threats that could compromise a professional accountant's compliance with the five fundamental principles and guidance on potential safeguards that may in certain circumstances mitigate such a threat. Two aspects are particularly common in corporate governance: conflicts of interest and confidentiality.

Conflicts of interest

Under paragraph 100.5, the fundamental principle of objectivity under the ICAS Code of Ethics inter alia requires professional accountants not to allow conflict of interest to override professional or business judgement. A professional accountant may be required to resolve a conflict (paragraph 100.18). Any such resolution process involves consideration of: (a) relevant facts; (b) relevant parties; (c) ethical issues involved; (d) fundamental principles related to the matter in question; (e) established internal procedures; and (f) alternative courses of action.

Appendix to Part A – Further guidance on ethical conflict resolutions – adds to paragraph 100.18. In considering the relevant facts, the professional accountant is advised to refer to the company's policies, procedures and code of conduct and also applicable laws and regulations. In ascertaining the relevant facts, the professional accountant may need to hold discussions with parties inside and outside the company.

In assessing courses of action, the professional accountant is required to consider values and principles adopted by society (i.e., does it pass the front-page-of-the-newspaper test?), long-term and short-term consequences, symbolic consequences, and public and private consequences.

A professional accountant has to determine the appropriate course of action, weighing the consequences of each course of action. The professional accountant is advised to document the issues, the details of any discussions held and the decisions made concerning that issue. If a significant conflict of interest cannot be resolved, the professional accountant may consider obtaining professional advice. In the case of a conflict of interest, such professional advice might be obtained from lawyers on an interpretation of the conflicts-of-interest requirements of Section 175 of the Companies Act 2006.

Confidentiality

Confidentiality is a fundamental principle of the ICAS *Code of Ethics*. A professional accountant should not disclose confidential information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose. Under paragraph 140.0, the principle of confidentiality is not only to keep information confidential but also to take all reasonable steps to preserve confidentiality.

Director contracts

Directors will have contracts documenting their duties and responsibilities. Executive directors (e.g., managing director, finance director) will have a director's 'service contract' / 'employment contract'. These contracts set out the usual terms and conditions of employment and also include specific provisions (e.g. conflicts of interest) arising from the employee being a director. A non-executive director's contract is usually in the form of a letter of appointment which not only sets out the terms and conditions for the position but also the expectations of the role (e.g., time commitment).

Decision making (Dilemmas 10-19)

As mentioned earlier, common law in many jurisdictions recognises the business judgement rule. Company directors are not expected to be infallible. The law recognises that errors of judgement will occur.

However, it is increasingly accepted that boards' approaches to decision making needs to be improved. Boards are now being urged to consider how the ways in which decisions are taken influences the quality of those decisions.

Under the FRC's (2011) *Guidance on Board Effectiveness*, boards are encouraged to consider how the way in which decisions are taken might affect the quality of those decisions. The guidance deals with two aspects of boards: board process and board behaviour.

Section 3 of the guidance deals with decision making. Integral to quality decision making are:

- high quality board documentation;
- expert opinions where necessary;
- adequate time for debate and challenge;
- achieving timely closure; and
- achieving clarity on actions required, timescales and responsibilities.

High-quality information is considered essential for quality decision making. It should be accurate, clear, comprehensive, up-to-date and timely. Board papers should contain a summary of their contents and inform directors of what is expected of them on that issue.

Impediments to good decision making are identified, including:

- dominant personality or group of directors;
- insufficient attention to risk, and treating risk as a compliance issue rather than as part of the decision-making process;
- failure to recognise the value implications of running the business on the basis of self-interest and other poor ethical standards;
- reluctance to involve non-executive directors, or of matters being brought to the board for sign-off rather than debate;
- complacent or intransigent attitudes;
- weak organisational culture; and
- inadequate information or analysis.

Most of these impediments relate to board behavioural issues rather than board process issues.

The FRC (2011: 8) references the key role of judgement in board decision making, implying the existence of bias in the boardroom for the first time when it uses the phrase 'distorted judgement'. The FRC acknowledges that flawed decisions can be made with the best of intentions and that competent individuals may believe passionately that they are making sound judgements. Judgements of even the most well intentioned experienced leaders can, in certain circumstances, be distorted.

The FRC (2011: 9) recommends extra safeguards which can be taken to mitigate the risks of distorted judgement in its guidance and these include:

- Describing in board papers the process used to arrive at and challenge the proposal prior to it coming to the board, thereby allowing directors not involved in the project to assess the appropriateness of the process as a precursor to assessing the merits of the project itself.
- Putting in place additional safeguards such as commissioning independent reports, seeking advice from experts, introducing a devil's advocate to provide challenge, establishing a sole purpose sub-committee, or convening additional meetings, to provide more opportunity to put the case at earlier stages, giving all directors the opportunity to share concerns or challenge assumptions well in advance of the point of decision.
- Reviewing past decisions, particularly ones with poor outcomes, with a focus on the decision-making process.

Behavioural issues (Dilemmas 20-23)

As mentioned earlier, the FRC's (2011: 8) *Guidance on Board Effectiveness* touches on behavioural effects on decision making in its use of the phrase 'distorted judgement'.

It is important to understand social psychological influences on boardroom behaviour.[24] Our desires powerfully influence the way we interpret information. When we are motivated to reach a particular conclusion, we usually do. Behavioural theory tells us that there are many unintended sub-conscious biases which distort the way we think about risk. Human beings misjudge risk. Sub-conscious thoughts cloud judgements. Being aware of these biases will lead to clearer thinking and better management of risk.

Bias is an inclination to present or hold a partial perspective at the expense of (possibly equally valid) alternatives. Sub-conscious or unconscious bias is hidden or implicit bias. Compared with deliberate conscious corruption, sub-conscious biased judgements cannot be regulated and therefore cannot be deterred by threats of sanctions. Rooting out bias, or tempering its effects, requires more fundamental changes to the way boards operate.

Errors in perception[25] involve:

- Focus on individuals rather than systems, which may result in overlooking more likely causes of a problem. Therefore, when things go wrong, it is not unusual for a scapegoat to be blamed.
- Self-interested motivations in the assignment of blame – to deflect blame from oneself. To make themselves look good, boards often fire the managing director/CEO rather than addressing more fundamental, systemic issues.
- Blurred moral responsibility involving acts of omission: whereas lies of commission are direct misstatement of the truth, lies of omission are acts of deception that occur because someone withholds information that deceives the target. Failure to disclose the truth makes it harder to assign responsibility. The ICAS Code of Ethics (paragraph 310.2) particularly references this when it talks about pressure to lie or to intentionally mislead (including misleading by remaining silent).

It is self-deception to believe we are objective Our inability to have a truly objective view of the world means we cannot evaluate the effect of our behaviour on others. Table 1 summarises some of the cognitive biases from which we suffer.

Table 1: Cognitive biases in judgement and decision making

Bias	Explanation
Anchoring bias	We rely too heavily on a past reference or on one trait or piece of information when making decisions, rooting oneself to an initial value, leading to insufficient adjustments of subsequent estimates.
Availability bias	Decision making influenced by events/experiences that immediately come to mind.
Cognitive dissonance	Holding two or more conflicting/contradictory beliefs; taking actions at variance with one's opinions.
Commitment bias	We remain committed to lost causes.
Confirmation bias	We persist with the same beliefs, discounting contrary evidence.
Groupthink	This bias is a particular feature of boards (also of juries: see Henry Fonda in the 1957 film *Twelve Angry Men*) as boards make decisions in groups.
Hindsight bias	Tendency to think events are more predictable than they are. We-knew-it-all-along bias.
Overconfidence biases	The tendency for people to be overoptimistic about the outcome of planned actions, to overestimate the likelihood of positive events, and to underestimate the likelihood of negative ones.
Pattern recognition biases	We do not anticipate events outside the pattern
Representation bias	We base our understanding on a pattern of recent experiences, events or beliefs which we consider to be representative.
Saliency biases	We overweight recent or highly memorable events.
Stability (inertia) biases	Preference for the status quo in the absence of pressure to change. We prefer to keep things as they are (Ronald Regan: 'status quo, you know, is Latin for 'the mess we're in'!').
Sunk cost fallacy	Paying attention to historical costs that are not recoverable. We are unwilling to accept losses. We throw good money after bad.

Source: Brennan, Niamh (2013), 'Psychological and behavioural influences on boards,' *Keeping Good Companies*, 65(8) (September): 457-461, p. 460.

The causes of bias arise from limitations in human thinking (called 'cognitive limitations') which impair decision making. We use rules of thumb (called 'heuristics') to simplify decision making in our everyday lives. For example, we often use intuition to make a quick decision. Our decision-making processes are heavily influenced by emotion.

Features of boardrooms conducive to bias

Company directing is a fertile ground for self-serving biases. There are a number of features of boardrooms that make them particularly conducive to bias.[26]

- Ambiguity – directing is an art, not a science and requires constant exercise of judgement.
- Attachment to company/management – one of the roles of non-executive directors is to oversee and monitor management on behalf of shareholders. In many boards, the non-executive directors do not meet the shareholders, but are interacting with, getting to know, establishing relationships with managers which makes monitoring more difficult.
- Approval – boards endorse or reject management's choices: self-serving bias becomes even stronger when endorsing others' biased judgements.
- Familiarity – people are more willing to harm strangers than individuals they know.
- Discounting – people are more responsive to immediate consequences than delayed ones. Boards may hesitate to implement tough decisions because the adverse consequences are immediate.
- Escalation – people conceal or wave away minor indiscretions; board biases may lead them to unknowingly adapt over time to small imperfections in management practices, which as the imperfections become larger may ultimately escalate into corruption.

Factors inhibiting effective decision making in the boardroom include dominant individuals, conflicts of interest/self-interest, poor ethical standards, emotional attachments, inappropriate reliance on previous experience and previous decisions, reluctance of management to involve non-executive directors or to bring matters to the board and complacent attitudes.

Mitigating the risk of sub-conscious biases

> *If we can accept the fact that the human mind has an infinite, creative capacity to trick itself, we can guard against irrational, unethical decisions.*[27]

There are ways of mitigating or overcoming bias. The FRC's (2011: 9) *Guidance on Board Effectiveness* recommends some steps to counteract distorted judgement:

- Executives putting their case at earlier stages, well in advance of the point of decision, so that directors have the opportunity and the time to share concerns and to challenge assumptions.
- Informing boards of the pre-boardroom processes adopted to arrive at management proposals.
- Informing boards of the pre-boardroom processes to challenge management proposals.
- Commissioning independent reviews of management proposals
- Seeking advice from experts.
- Taking large decisions in stages, e.g., concept; proposal for discussion; proposal for decision.
- Introducing processes that allow time for reflection.
- Considering the possibility it might be the wrong decision.
- Finding reasons not to agree with management's proposals.
- Allocating different roles within boards.
- Deliberately introducing a devil's advocate to provide challenge.
- Introducing automatic stops in decision making in the form of circuit breakers, mental breakers or calling for time-outs (an increasingly common feature of surgical theatres).
- Establishing a sole-purpose sub-committee, convening additional meetings.
- Recording the pros and cons of the decision in the minutes.
- Removing management more quickly after problems emerge.

Information asymmetry (Dilemmas 24-27)

When companies fail, boards get blamed – either they knew and were complicit, or did not know and were incompetent. At the heart of corporate governance is the need to address information asymmetry between various parties. Information asymmetry is the difference between the company-specific information available to management and what is presented to boards. Main Principle B.5 of *The UK Corporate Governance Code* requires that: 'The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties.' The UK Code of Governance sets a high standard for board information governance, placing a particularly heavy burden on chairmen, stating that 'the chairman is responsible for ensuring that the directors receive accurate, timely and clear information'. The Code goes on to state that 'management has an obligation to provide such information, but directors should seek clarification or amplification where necessary'. Corporate governance failure is frequently accompanied by information asymmetry whereby the non-executive directors were not aware of what was going on.

The FRC's (2011: 8) *Guidance on Board Effectiveness* comments 'Good decision making … [is] facilitated by … high quality board documentation.' Mindful of the information asymmetry between executive and non-executive directors, executive directors have a very particular duty to present clear executive insights to non-executive colleagues who may not have an in-depth understanding of the business. Executive directors have to wear their director hat in the boardroom. The term 'wearing their director hat'[28] reflects the ability of executive directors to carry out their director (rather than management) role, which critically includes sharing information with boards.

While information asymmetry is a risk, its existence is seen by some as essential for board effectiveness.[29] Notwithstanding the external knowledge and experiences that non-executive directors bring to the board, they can never have the detailed day-to-day information of the business operations and/or detailed knowledge of the industry that managers have. Many consider boards unable to carry out their duties because they do not know as much about the business as management. On the face of it this is alarming. It is less so when board and management information are considered to be different but complementary. The information set of managers is characterised as being largely implicit and tacit – a 'locked in' dimension of human experience. Boards, on the other hand, require more formal, explicit information. Board processes require managers to document implicit and tacit information, which can then be subject to questioning and challenge during board meetings, which in turn generates additional information. Were non-executive directors to have the same information set as managers, there would be no questions for them to ask at board meetings, no challenges to make of managers. Thus, it is the information asymmetry between mangers and non-executive directors that provides the necessary conditions for non-executive directors to make their added-value contribution to board decision making.

Conduct of board business (Dilemmas 28-34)

The conduct of board business is as variable as the human beings who make up boards of directors.

Confidentiality

A particularly difficult issue of relevance to boards can be the question of confidentiality. The requirement for confidentiality by boards is fundamental to good governance, yet it is rarely, if ever, mentioned in best practice guidelines. For example, the FRC makes no reference to confidentiality in *The UK Corporate Governance Code*, nor is it referred to in the FRC's (2011) *Guide to Board Effectiveness*. In relation to institutional investors (but not boards), the FRC's (2012: 10) *Stewardship Code* comments: 'Confidentiality in specific situations may be crucial to achieving a positive outcome'.

Confidentiality is often (but not always) referred to in board terms of reference documents.

In practice, confidentiality can be challenging for boards, and for this reason a dilemma on this topic is included.

Board process

Other aspects of board conduct should not be left to chance. The conduct of board business is greatly enhanced by documented formal board processes. For example, detailed terms of reference for the board and its sub-committees are essential. They set out basic housekeeping issues such as membership, chairing of meetings, quorums, frequency of meetings. Misunderstandings are more likely in the absence of professionally assembled internal governance documents.

3 THE CASE STUDY DILEMMAS

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DIRECTORS' DILEMMA 1: DIRECTOR TENDERING FOR COMPANY CONTRACT

The scenario

You are the chairman of a public body. The board entirely comprises non-executive directors.

The financial controller contacts you in connection with the tender for a very substantial security contract which is about to go public. Clear criteria have been drafted for the basis of awarding the tender. She mentions that she had been contacted by a board member, who drew the financial controller's attention to his ownership of a company providing security services, requesting that he be notified when the tender goes public.

Question:

Should the board member be permitted to tender for the contract in the company?

DIRECTORS' DILEMMA 1: DIRECTOR TENDERING FOR COMPANY CONTRACT

Analysis - Issues to consider/debate

- How does the governance of public bodies differ from the governance of, say, publicly listed companies?
- How are board directors of public bodies selected? How should they be selected?
- If invited to become a board director of a public body, what would be the risks and rewards of holding such a position?
- How should the chairman handle this issue?
- How should the public body handle the tender?
- Should the non-executive director have contacted the financial controller?
- What are the implications of the non-executive director contacting the financial controller?
- What would be the external perceptions if the non-executive director's company got the contract?
- How would unsuccessful tenderers react if the non-executive director's company got the contract?
- Can the board impartially oversee and monitor the service provision arrangements if the non-executive director's company gets the contract?

DIRECTORS' DILEMMA 1: DIRECTOR TENDERING FOR COMPANY CONTRACT

Formulating a course of action

This dilemma concerns a conflict of interest of a non-executive director which has been reported to the chairman by the financial controller. Crucial to board performance is a chairman who sets the tone and style of board dynamics. In this dilemma, the chairman has to set the tone by ensuring that board members do not use their position of power in the company for personal advantage. At the same time, the chairman has to preserve well-functioning interpersonal dynamics consistent with board effectiveness. The non-executive director has put board dynamics at risk by considering using his board position for personal advantage. The chairman has to resolve this matter while at the same time maintaining the trust necessary for effective board performance.

Identification of key parties to the dilemma

There are three key parties to this dilemma:

- Chairman: The chairman of the board has to decide what action to take in relation to the board member who has expressed an interest in the tender when it is advertised publicly. The chairman has a number of choices. The chairman may decide to do nothing but keep a close watch on the situation. Alternatively, she may have a conversation with the board member. Such a conversation requires tact and sensitivity. The chairman has to be careful not to negatively affect the board dynamic and social chemistry in the boardroom. The chairman might handle this by circulating a general note to all board members reminding them of their legal duties not to let personal advantage interfere with their duties to look after the best interests of the company/shareholders as a whole. Circulating such a note has to be done with care such that it does not lead to rumours. Provisions of the board terms of reference dealing with conflicts of interest might also be brought to the board's attention. Bringing the matter formally to the board is another alternative, which could also present some difficulties for board dynamics. Finally, the chairman could deal with the matter indirectly through the financial controller.
- Non-executive director: Is it appropriate for a board member to approach a member of staff outside the boardroom and concerning a matter of personal interest to the board member? The board member has to decide whether it is appropriate for his company to tender for a substantial contract. If the non-executive director's company tenders for the contract, transparency will be critical.
- Financial controller: The financial controller is clearly concerned that the board member contacted her and is concerned that the board member's company is considering tendering for the substantial contract. The financial controller has to decide whether: (i) it is appropriate to respond to the board member's request; and (ii) to re-consider the terms and criteria to be applied in determining the award of the contract. It is not necessary for the financial controller to inform the board member as the tender will be publicly advertised. All parties interested in tendering, including the board member, will have access to that public information. Can the board member be stopped from tendering for a publicly advertised contract? The financial controller's course of action and response to the non-executive director, if any, will follow discussion with the chairman. The wording of the tender documents addressing conflicts of interest might be revisited.

Legal regulations to be considered and any pertinent associated case law

The chairman has to consider whether a conflict of interest applies under Section 175 of the Companies Act 2006 (see Chapter 2). Under this section, it appears that the non-executive director has a conflict with the interests of the company in particular relating to exploiting an opportunity (a substantial tender opportunity) arising from his position as board member.

Guidance from codes of best practice such as The UK Corporate Governance Code

Codes of best practice deal less with judgement issues such as conflicts of interest and more with board process. Supporting principle A.1 of *The UK Corporate Governance Code* requires all directors to act in the best interests of the company consistent with their statutory duties under sections 170-177 of the Companies Act 2006. The Code only mentions conflicts of interest once, in connection with executive remuneration.

DIRECTORS' DILEMMA 1: DIRECTOR TENDERING FOR COMPANY CONTRACT

Application of ethical principles

Professional guidance on conflicts of interest under the ICAS *Code of Ethics* is discussed in Chapter 2. The guidance applies to professional accountants in business, such as the chairman of the board in this dilemma. While the chairman does not have a conflict of interest directly, she is responsible for handling such a situation, which if handled incorrectly may have implications for the chairman herself. Under the ICAS *Code of Ethics*, the chairman may refer to the company's policies, procedures and code of conduct and also applicable laws and regulations. Thus, it is important for those carrying governance responsibilities to ensure that the company has in place appropriate robust policies, procedures and codes of conduct.

How would the actions of the directors look if they appeared on the front page of a national newspaper? The chairman has to ensure that the board, at the level of each individual director, passes the 'front-page-of-the-newspaper test'. With Freedom of Information Act 2000 provisions, which apply to public bodies, there is a risk of this matter getting into the public domain. The chairman may consider obtaining professional advice which in the case of this dilemma, might be obtained from lawyers on an interpretation of Section 175 of the Companies Act 2006 in the context of the company's substantial tender. However, were the issue to get to that stage, it could compromise board dynamics.

DIRECTORS' DILEMMA 2: BENEFICIARIES OF FUNDRAISING FOR A NOT-FOR-PROFIT ORGANISATION

The scenario

You are the newly appointed CEO of a not-for-profit organisation, structured as a company limited by guarantee. The board of the organisation consists of seven voluntary, non-executive directors and the non-executive chairman of the board. While not a member of the board, the CEO is secretary to the board and attends all board meetings in that capacity.

You have been approached by the chairman of the board who has asked you to fundraise for a project that the chairman is undertaking. While the organisation itself will be a beneficiary of the project, the main financial and other benefits will accrue directly to the chairman.

Concerned about the chairman's request, the CEO approaches another long-serving non-executive director to seek advice. The advice the CEO receives is 'don't be too worried about it, the chairman has operated like that for years'.

Question:

Should the CEO support the chairman's fundraising efforts?

DIRECTORS' DILEMMA 2: BENEFICIARIES OF FUNDRAISING FOR A NOT-FOR-PROFIT ORGANISATION

Analysis – issues to consider/debate

- Does the chairman have a conflict of interest?
- What are the implications of the chairman's actions?
- Is the behaviour of the long serving member of the board appropriate?
- If you were the CEO, what would you do?
- If you were the CEO, are there any risks to you from this arrangement?
- What governance processes could protect the organisation in this situation?
- How would the organisation document appropriate governance processes to protect the organisation in this situation?

DIRECTORS' DILEMMA 2: BENEFICIARIES OF FUNDRAISING FOR A NOT-FOR-PROFIT ORGANISATION

Formulating a course of action

This conflict-of-interest dilemma differs from Dilemma 1 in that it is the chairman who has the conflict of interest. The party who is concerned about this is the CEO. This is a particularly awkward situation as the relationship between chairman and CEO is so influential on board dynamics and board effectiveness.

A feature of some corporate governance irregularities is taken-for-granted 'we've always done it this way' assumptions. The comment by the long-serving non-executive director points to this being a problem in this dilemma.

Identification of key parties to the dilemma

There are three key parties to this dilemma:

- Chairman: It appears that the chairman of the board is requesting the CEO to fundraise for a project from which the chairman (as well as the organisation itself) will benefit. As the chairman is the 'main' beneficiary of the project, she has a clear conflict of interest. She is personally benefiting from her governance position as board chairman. The organisation is losing out and should arguably be the recipient of all the financial and other benefits from the project. Further adding to the dilemma, this has been going on 'for years'. If the not-for-profit organisation has charitable status, would the chairman benefiting from the project put that status under pressure/question?
- CEO: The CEO, who is not a member of the board, is being asked to assist with this matter, of which he has concerns. The issue is a difficult one for the CEO. If he challenges the chairman, it could put his job in jeopardy. If he acquiesces to the chairman, he may be putting his own integrity and reputation at risk. A possible course of action for the CEO is to commission a governance expert to educate the board on conflicts of interest and directors' fiduciary duties. An immediate course of action for the CEO would be to request the Chairman to get the whole board to approve the Chairman's request. The CEO might also ensure that his concerns are formally recorded in the board meeting minutes. In addition, the CEO should also request the board to formally agree its policy on disclosure to members.
- Other board members: It would appear that the board has acquiesced to this project for years.

Legal regulations to be considered and any pertinent associated case law

Under Section 175, it is likely that the proposed fundraising would be construed as a direct conflict between the organisation's interests and those of the chairman. The issue is somewhat muddied arising from the company deriving some benefit from the fundraising. A role of the CEO would be to fundraise for the organisation, not for the chairman's project. That the chairman's project would benefit the company to some extent (which benefit is not specified or quantified) does not justify the CEO acting for a project other than one for the benefit of the organisation.

Companies are required by law to observe the provisions of accounting standards. These require companies to make certain disclosures in their financial statements. Disclosure of information can be a potent tool for doing the right thing. It is not clear from the dilemma whether members of the not-for-profit organisation will be/have been told of the arrangements with the chairman. For example, has this been/will it be disclosed in the financial statements as part of the related party transactions note? Under *International Accounting Standard(IAS) 24 Related Party Disclosures*, directors (and their close family members) are classified as related parties. If there have been transactions between related parties and the organisation, the financial statements should disclose the nature of the related party relationship, the monetary amount of related party transaction, any balance sheet (statement of financial position) amounts outstanding, in sufficient detail necessary for an understanding of the financial statements. Related party disclosures are also required of small and medium-sized companies and micro entities, for example, as set out in the International Financial Reporting Standard for Small and Medium Sized Enterprises and in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*.

Guidance from codes of best practice such as The UK Corporate Governance Code

Supporting principle A.1 of *The UK Code of Governance* states that 'All directors must act in what they consider to be the best interests of the company, consistent with their statutory duties', which are set out in the Companies Act 2006. The verbal hedging in this supporting principle, i.e. 'in what they consider to be' captures the subjective nature of being a director. In legal terms, this is sometimes referred to as 'the business judgement rule'. Directors are not expected to be infallible!

An aspect of this dilemma is that some of the directors are 'long-serving'. This can be a particular issue with not-for-profit voluntary boards. The problem with lengthy terms of office is that taken-for-granted norms may become established and unchallenged. Regular refreshment of boards provides an opportunity for new directors with a fresh perspective to challenge taken-for-granted norms. Ideally, the articles of association should require directors to regularly retire and offer themselves for re-election.

Under *The UK Corporate Governance Code*, there is no prohibition on lengthy service on boards. However, service of more than nine years is one of the seven independence criteria of the Code. If a director has served more than nine years, code provision B.1.1 requires the board to explain why such a director is classified as independent.

Application of ethical principles

The ICAS *Code of Ethics* (Part A General Application of the Code and Part C Professional Accountants in Business) applies to the CEO and all members of the board who are professional accountants. Where a professional accountant in business comes under pressure to act or behave in ways contrary to the fundamental principles of the ICAS Code of Ethics, that person is expected to apply the conceptual framework approach of the Code. This requires the professional accountant to identify, evaluate and address threats to compliance with the five fundamental principles set out in Chapter two.

In this instance, the CEO is arguably facing pressure to: (i) assist the chairman to act contrary to law (Section 175, Companies Act 2006); and (ii) by assisting the chairman, to himself act contrary to professional standards as set out in the ICAS *Code of Ethics*.

Relevant to this dilemma is paragraph 310.1 of the ICAS *Code of Ethics*, which references pressure on professional accountants in business to lie to others or to intentionally mislead (including misleading by remaining silent). Silence is a form of deception. Thus, standing by and saying nothing where someone has concerns is potentially unethical under the ICAS *Code of Ethics*.

DIRECTORS' DILEMMA 3: CHAIRMAN'S CONFLICT OF INTEREST

The scenario

David is a long-standing expert in the airline business. He has been non-executive chairman of a large listed low-cost airline, RA plc, for 16 years.

A recent Sunday newspaper has revealed that David's own multi-million dollar investment company, which he co-founded some years ago, is a bidder for an airport that is up for sale. RA plc is the airport's biggest customer and has, until recently, also been interested in buying the airport.

Question:

Should the chairman, through his investment company, bid for the airport that is up for sale?

DIRECTORS' DILEMMA 3: CHAIRMAN'S CONFLICT OF INTEREST

Analysis – issues to consider/debate

- Is David a suitable chairman of RA plc?
- Does David have a conflict of interest?
- If David has a conflict of interest, how should it be handled at the RA plc board?
- If David has a conflict of interest, how should it be handled at his investment company board?
- What are the issues concerning this matter from the managing director of RA plc's point of view?
- What are the issues concerning this matter from the board of RA plc's point of view?

DIRECTORS' DILEMMA 3: CHAIRMAN'S CONFLICT OF INTEREST

Formulating a course of action

This dilemma is similar to Dilemma 2 in that the conflict of interest relates to the chairman. Unlike Dilemma 2, the chairman does not currently have a conflict of interest. There is no evidence that the chairman influenced RA plc in dropping its interest in buying the airport. However, the proposed transaction through his company could potentially result in a conflict of interest, arising from RA plc being the biggest customer of the airport the chairman's company is contemplating buying. Unlike Dilemma 2, this conflict of interest is not directly between the chairman and the company, RA plc. Rather, it potentially arises indirectly because of the chairman's potential ownership (through his investment company) of a supplier to RA plc.

Identification of key parties to the dilemma.

There are four key parties to this dilemma:

- Chairman David: It appears that the chairman of the board may be contemplating a transaction which, if it proceeds, could introduce a significant conflict of interest for him.
- It is not clear that buying another company that has a relationship with RA plc involves an insurmountable conflict of interest for the chairman. Inevitably, from time to time, directors may have a conflict of interest with their company. However, in this case, pricing of the airport services to RA plc is at the heart of the conflict of interest and is fundamental. Thus, it appears that the conflict of interest for David if his company purchases the airport could be so systematic as to suggest his continuing position on the RA plc board would be inappropriate.
- If David's company decides to go ahead with the tender, should David remain on the board of RA plc at that stage?
- The wording of the dilemma ('A recent Sunday newspaper has revealed') implies that information on the proposed transaction may not have been known to the board prior to the newspaper article. Such information asymmetry between the chairman and his board may undermine trust on the board.
- Board terms of reference documents usually set out how such occasional conflicts of interest are to be handled. They are usually handled by conflicted directors not receiving board papers relating to the issue of conflict, not receiving minutes of meetings recording how the issue was dealt with by the board and absenting themselves from parts of the meeting where the issue of conflict is being discussed.
- Senior independent director (see below): This non-executive director should act as mediator between the views of the chairman and the views of other directors on the board.
- Other directors: Other directors will have to make their views known on the proposed transaction, possibly through the senior independent director. If the transaction takes place, other directors should require full transparency to the shareholders of the event.
- External auditors: If the transaction goes ahead, it may have to be disclosed in the annual report as a related party transaction and be subject to questioning at the next annual general meeting. Obtaining the advice of the finance director, supported possibly by advice from/briefing by the external auditors to the board as part of their audit, on the disclosures required by law and by accounting standards would ensure directors have clarity on the consequences of the transaction proceeding.

Legal regulations to be considered and any pertinent associated case law

As outlined in the discussion of Dilemma 2, *IAS 24 Related Party Disclosures* requires the disclosure of related party transactions. In defining related parties, a distinction is made between persons and entities who are related parties. A person (e.g., David, the chairman) who is a director is a related party of the company. An entity is a related party of the company where the entity is controlled or jointly controlled by a director of the company. It would appear, therefore, that David's company is a related party to RA plc. The entity is David's own, which he co-founded, and therefore is probably controlled by him. The consequences of RA plc and David's entity being related parties is that the transactions between the two will have to be disclosed in the annual financial statements. This could cause proprietary information (i.e., valuable private commercial information) to be revealed publicly.

DIRECTORS' DILEMMA 3: CHAIRMAN'S CONFLICT OF INTEREST

Guidance from codes of best practice such as The UK Corporate Governance Code

Supporting principle A.1 of *The UK Corporate Governance Code* states that 'All directors must act in what they consider to be the best interests of the company, consistent with their statutory duties', which are set out in the Companies Act 2006.

Code provision A.4.1 of *The UK Corporate Governance Code* requires (on a comply-or-explain basis) the appointment of one of the independent non-executive directors as senior independent director. The role of the senior independent director is inter alia to act as a sounding board for the chairman, as an intermediary for the other directors and as an extra channel of communication for shareholders (in addition to the managing director and chairman) for unresolved concerns.

David has been serving as chairman for 16 years. Code provision A.3.1 of The UK Corporate Governance Code requires (on a comply-or-explain basis) the chairman on appointment to meet the seven independence criteria under Code provision B.1.1. One of these is service on the board of more than nine years. Given the chairman's tenure, should the board be considering succession planning for this role?

Application of ethical principles

It is not clear from this dilemma that there is an insurmountable conflict of interest in this case. If David's company purchases the airport, this will result in a conflict of interest, which of itself is not unethical. It is a question of how the conflict of interest is handled. David will be privy to detailed financial information concerning RA plc. A supplier (such as David's company) to RA plc with such detailed financial information could use the information to its advantage. For example, there is a risk that the detailed financial information could be used during pricing negotiations with RA plc. This suggests that the conflict of interest in this dilemma is systematic. All board meetings of RA plc would consider detailed financial information of RA plc. It would be inconceivable for the chairman to have to leave every meeting of RA plc. It would be unworkable for the chairman not to receive financial information on RA plc.

DIRECTORS' DILEMMA 4: CONFLICTED DIRECTORS ON THE BOARD

The scenario

You are a non-executive chairman of a publicly owned commercial company operating in a sector of national importance. The publicly owned commercial company is a monopoly supplier to this sector.

Board appointments are made by the government. The managing directors of two of the largest operators in the sector/customers of the monopoly supplier are well-known supporters of the political party in government. They have recently been appointed as non-executive directors to the board of the monopoly supplier.

You have received angry complaints from the remaining five large operators in the sector, who are concerned at the competitive advantage accruing to the two recently appointed directors on the 'inside track' with the monopoly supplier.

The question of pricing of product to the sector/customers is an agenda item at the forthcoming board meeting.

Question:

How should conflicts of interest on the board be handled?

DIRECTORS' DILEMMA 4: CONFLICTED DIRECTORS ON THE BOARD

Analysis – issues to consider/debate

- Should governments be permitted to appoint directors to publicly owned companies?
- If you think governments should not be permitted to appoint directors to publicly owned companies, how should such directors be appointed?
- If invited to become a director of a publicly owned company, what would be the risks and rewards of holding such a position?
- How should the chairman handle the issue?
- How should the company handle the issue?
- How should the issues concerning the two directors be handled at board level?
- What should the remaining five large operators in the sector do?
- What are the implications of the board composition for information at board level?

DIRECTORS' DILEMMA 4: CONFLICTED DIRECTORS ON THE BOARD

Formulating a course of action

This fourth of six conflicts of interest dilemmas has new twists not shared by the earlier dilemmas. This conflict of interest arises because the shareholder (the government in this instance) chose to appoint two large customers with systematic conflicts of interest to the board. The problem is exacerbated by the publicly owned company being a monopoly supplier. All other customers are likely to (rightly or wrongly) perceive that the two customers on the board of the monopoly supplier may be on the inside track, able to procure the best quality products and to get products at preferential prices.

Identification of key parties to the dilemma

There are five key parties to this dilemma:

- Chairman: The chairman has to ensure that to the greatest extent possible there is confidence between the monopoly supplier and its customers. The board has to be, and be seen to be, handling conflicts of interests of the two directors in a manner which gives confidence to other customers that the two directors do not have an 'inside track' with the monopoly supplier. The chairman is responsible for briefing the appointing government minister, inter alia advising her of the difficulties posed by appointing people to the board who have systematic conflicts of interest and of the consequences for the board and the state monopoly supplier of having seriously conflicted directors on the board.
- Conflicted non-executive directors: Presumably, the reason the government appointed two customers to the monopoly state supplier board is to have customer views represented at board level. The conflicted directors need to adopt the highest standards in how they handle their conflicted positions. This would involve communicating up to the board the views of customers, while not breaching confidentiality and communicating down to customers (their competitors!) confidential information obtained at board meetings. The two directors need to ensure that transactions between their businesses and the monopoly supplier are at arm's length. This may be achieved by appointing another of their employees to negotiate purchases with the monopoly supplier. The two directors will need to absent themselves from parts of board meetings dealing with decisions where they are conflicted. Given the dilemma, these absences could happen frequently.
- Other directors: The board may need to put in place special arrangements to ensure that the company does not leave itself open to the reputational risks of being accused of behaving unfairly to its customers. Given that the monopoly supplier is a publicly owned company, the reputational risks are arguably higher than in a normal commercial situation, because of the political-business interface in which a publicly owned entity has to operate. There are also reputational risks for board members other than the two recently-appointed directors in the event that the conflicts of interests are not handled properly. They will therefore have a strong self-interest in ensuring proper process in the boardroom. The chairman, company secretary and board will have to put in place robust and detailed procedures identifying the circumstances when there is a conflict of interest in the boardroom, and agreeing procedures for handling the conflict of interests, including: (i) arrangements whereby the two directors do not receive certain board meeting papers containing proprietary (private, commercially valuable) information; (ii) requiring the two directors to absent themselves from board meetings during certain discussions; and (iii) dealing with the related party transaction disclosures relating to transactions between the monopoly supplier and the companies of the two directors.
- Company secretary: The board will rely on the company secretary to ensure that the two directors do not receive sections of board minutes and board papers dealing with proprietary issues and containing proprietary information.
- Government: Government ministers and civil servants need to understand the importance of appointing suitably qualified individuals to publicly owned company boards. This includes avoiding appointing those that have a systematic conflict of interest with the company. Representatives of customers of a monopoly supplier are likely to be systematically conflicted. Alternative efforts are required to find suitable people with expertise of the sector who are not customers of the monopoly supplier.

Legal regulations to be considered and any pertinent associated case law

Under common law, now codified in Section 172 of the Companies Act 2006, directors are required to act *bona fides* in good faith in the interests of the company. This implies that directors are required to act honestly and not to profit at the expense of the company. The fiduciary duty of directors also implies a duty to maintain confidentiality and not to use company information other than for the benefit of the company. Section 175 (see Chapter 2) deals with conflict of interest.

DIRECTORS' DILEMMA 4: CONFLICTED DIRECTORS ON THE BOARD

Judging conflict of interest/fiduciary duty common laws is subjective. The courts will interfere only if no reasonable director could possibly have concluded that a particular transaction was in the best interests of the company. The standard therefore against which conflicts of interest are judged is therefore the perceptions of reasonable persons.

Guidance from codes of best practice such as The UK Corporate Governance Code

Supporting principle A.1 of *The UK Code of Governance* states that 'All directors must act in what they consider to be the best interests of the company, consistent with their statutory duties', which are set out in the Companies Act 2006.

Application of ethical principles

The two non-executive directors/customers need to take proactive steps to ensure that they act and are seen to act objectively, not allowing their conflicts of interest to interfere with their professional or business judgement. The board needs to support these two directors in executing their duties in a manner that protects them from accusations of inappropriate handling of their conflicts of interest.

Other considerations

The dilemma mentions that pricing of product is on the agenda for the next meeting. This may present the board with an opportunity to consider mechanisms to introduce a more transparent, arm's length approach to pricing in which all customers would have more confidence, which is particularly important in the case of a monopoly supplier, and even more important for a publicly owned company, given political sensitivities. Some kind of process might be considered whereby the product of the monopoly supplier is provided to customers by means of a public auction/tender system to provide a more transparent set of product prices.

DIRECTORS' DILEMMA 5: NON-EXECUTIVE DIRECTOR'S CONFLICT OF INTEREST

The scenario

Donna sold her business to AEX plc, a listed company, receiving £40 million in AEX shares and a seat on the board. She is categorised as a non-independent ('grey'), non-executive director by virtue of being a large shareholder in AEX plc. Since the deal, the share price has been relatively static over the past two years.

Donna has participated actively in the board since her appointment and believes she would be in the running for the chairman's role if the current chairman (age 74) decides to retire.

Donna borrowed £100 million to purchase property, using her AEX plc equity as security for the debt. However, her tenant went into liquidation six months ago and the property is now empty. Meanwhile Donna's bank has valued the empty unit at £60 million and is putting her under pressure to sell it and her AEX plc shares in order to pay down her debt.

Last week the managing director announced his intention to depart in 12 months. When doing so, he revealed that AEX plc's West African subsidiary has been storing a toxic waste by-product for the past 20 years which, although not illegal in that country, would be upsetting to environmentalists and the general public. He has known of this problem for some time. If made public, this might have a serious effect on the AEX plc share price. The managing director has refused to consider dealing with the issue (possibly because any impact on the share price would affect his share option values). The managing director has met with the non-executive directors who will nominate his successor and has recommended finance director Sylvia who shares the managing director's attitude to the West African time bomb.

Donna's interest payments are already in arrears and she feels she cannot stall the Bank beyond next month when an interest payment comes due. She must make a decision and believes she has three choices:

i. Resign immediately as a director of AEX plc and quietly sell her £40 million equity.

ii. Stall her bank until the end of the close period during which directors cannot deal in shares in the company, when she can sell her £40 million equity into the market which would solve her cash flow crisis.

iii. Resign from the board in protest at managing director's refusal (backed by a majority of the board) to deal with the West African time bomb.

Question:

How should Donna handle her conflict of interest?

DIRECTORS' DILEMMA 5: NON-EXECUTIVE DIRECTOR'S CONFLICT OF INTEREST

Analysis – issues to consider/debate

- What are the implications of Donna resigning as a director of AEX plc?
- What are the implications of Donna selling her shares in AEX plc following her resignation as a director?
- What are the implications of Donna stalling her bank?
- What are the implications of Donna selling £40 million shares in AEX plc to solve her cash flow crisis?
- What are the implications of Donna resigning from the board in protest over the managing director's handling of the West African time bomb?
- How should the West African time bomb be handled by the board?
- Should the finance director Sylvia become the next managing director?

DIRECTORS' DILEMMA 5: NON-EXECUTIVE DIRECTOR'S CONFLICT OF INTEREST

Formulating a course of action

This fifth conflict-of-interest dilemma has a number of issues happening at the same time, which is often the case in real life. First there is Donna's conflict of interest as a large shareholder, which is exacerbated by her personal financial difficulties. Second, there is the succession of the 74-year old chairman. Third, there is the replacement of the managing director. Finally, there is the West African environmental time bomb, and that the managing director has been sitting on this information unknown to the board.

Identification of key parties to the dilemma

There are four key parties to this dilemma:

- Donna, non-independent, non-executive director: Donna is a board member by virtue of her large shareholding in AEX plc. As such, she is not an independent non-executive director. She potentially has a conflict of interest between her own interests as a large shareholder in AEX plc versus her duty to look after the interests of the company. Individual shareholder interests and company interests are not always aligned. In particular, Donna has to be careful in handling price-sensitive inside information she will obtain as a board member, which may make selling her shares difficult, risking the accusation of insider trading. Her knowledge of the highly price-sensitive information concerning the West African environmental time bomb makes is almost impossible for her to sell her shares before this information is released publicly to the market. Thus, resigning immediately and selling her shares quietly is not a (legal) option for Donna.
- 74-year old chairman: Given his current age, the chairman should consider initiating succession plans for his replacement. The succession procedures should not favour any one board member, and should be conducted in a fair and equitable manner, providing all board members with confidence and ensuring that the best person gets the job. *The UK Corporate Governance Code* provides guidance on appointments to boards (see below).
- Non-executive directors: Arguably, the most important role of a board, led by the chairman, is the appointment of managing director. The board should agree a formal arm's length process to replace the managing director, which process should ensure that the best candidate is selected in the best interests of the company.
- Managing director: The managing director has withheld material price-sensitive information from his own board and, as a result, from the market, which may be a dismissal offence. The refusal of the managing director to deal with the matter is arguably gross insubordination. That the managing director does not see withholding the information as illegal also raises concerns about his competency.

Legal regulations to be considered and any pertinent associated case law

For the effective functioning of the markets, two principles must operate: (i) listed companies must release all relevant information as soon as it is available; and (ii) everyone dealing in shares must have access to the same information at the same time.

Insider trading (also called insider dealing, or market abuse) is a criminal offence under Part V of the UK Criminal Justice Act 1993. People in possession of inside information which is price-sensitive, and who deal in shares, are guilty of the offence. Inside information/price-sensitive information is information which, if it were published, would have a significant effect on the share price.

The UK Listing Authority *Disclosure Rules and Transparency Rules*[30] apply to companies listed on the London Stock Exchange. Such companies are required to release without delay to the London Stock Exchange Regulatory Information Service all inside information that would be likely to have a significant effect on the share price.

Thus, for the board not to release the information on the West African environmental problem breaches these rules and exposes the directors to offences, the risk of penalties and reputational risks. The managing director's 'refusal to deal with the issue', i.e., refusal to abide by the rules of the London Stock Exchange, is potentially grounds for dismissal. The board must ensure that the information is released immediately to the market, including overseeing the wording of the announcement. Having the matter dealt with is the proper course of action by the board.

DIRECTORS' DILEMMA 5: NON-EXECUTIVE DIRECTOR'S CONFLICT OF INTEREST

Under their common law duty to exercise due care and skill, directors may delegate to others provided those other parties are honest and competent. The managing director appears to have been dishonest in withholding material information from his board. The lack of appreciation by the managing director of insider trading rules, and his persistency in not disclosing the West African time bomb also raises questions over his competency. This makes continued delegation by the board to the managing director questionable.

Guidance from codes of best practice such as The UK Corporate Governance Code

Under *The UK Corporate Governance Code*, the chairman of the board should (on a comply-or-explain basis) be independent on appointment as chairman. Ultimately it is for the board to decide who to classify as independent. However, the Code identifies seven relationships or circumstances that may be relevant in determining independence. One of these is 'represents a significant shareholder'. Following this, Donna would not be considered to be an independent non-executive director and therefore would not be suitable for appointment as chairman, notwithstanding her wish to become chairman.

The UK Corporate Governance Code contains provisions for nomination committees, whose role it is to assist boards in selecting new board members, including a new chairman. Code provision B.2.1 requires a majority of the nomination committee to comprise independent non-executive directors. Thus, Donna would not be precluded from being a member of the nomination committee. The chairman of the board may chair the nomination committee except where that committee is dealing with the appointment of a successor chairman.

The nomination committee of the board, or a special-purpose sub-committee, is required to put in place a proper process for selecting and appointing a successor managing director.

Application of ethical principles

Paragraph 310.1 of the ICAS *Code of Ethics* is relevant to this dilemma. Under the ICAS *Code of Ethics*, professional accountants in business should not lie to others, or intentionally mislead (including misleading by remaining silent). The managing director appears to have breached these standards by not disclosing the West African environmental time bomb to his board. Apart from being illegal, for directors not to disclose inside price-sensitive information would be unethical under the *Code of Ethics*.

DIRECTORS' DILEMMA 6: SHOULD DIRECTORS ACT ON SHAREHOLDER DEMANDS?

The scenario

You are the chairman of a publicly listed company with a long-standing track record of solid performance.

Part of your duties is liaison with shareholders, particularly substantial shareholders. The substantial shareholders in your company are all institutional investors managing pension fund monies. The investment managers are highly incentivised, their remuneration being heavily dependent on the annual performance of the share price.

Managers of the top three institutional investors in your company have approached you expressing their concern at the extremely conservative way in which the company is managed which they believe has depressed the share price of the company. Their view is that the management team is old fashioned, 'fuddy-duddy' and have not adopted more modern methods of financing the business, and of accounting for the business activities.

They have also challenged the refusal of the company to abandon a large investment in a developing country (which is not profitable but is breaking even), which they believe is heavily depressing the share price. You respond that de-investing from that country would cause terrible poverty. The investment managers respond that this is not their problem. Their job is to provide the shareholders with the best return on their capital.

The investment managers have said that unless more modern practices are adopted, and unless the board agrees to abandon the investment in the third world country, they will sell their shares in the company.

Question:

How would you as chairman respond to these institutional investors' requests?

DIRECTORS' DILEMMA 6: SHOULD DIRECTORS ACT ON SHAREHOLDER DEMANDS?

Analysis – issues to consider/debate

- What are the stock exchange requirements concerning communicating with institutional shareholders?
- What are the corporate governance code requirements concerning communicating with institutional shareholders?
- What are the risks and rewards to the company in relation to this issue?
- What are the board's duties and responsibilities in relation to the company shareholders?
- Is it appropriate behaviour for institutional investors to approach a listed company chairman?
- Is it appropriate behaviour for institutional investors to instruct a listed company on how to run its business?
- Is it appropriate behaviour for institutional investors to threaten to sell their shares if their wishes are not met?
- How might the interests of the institutional investors conflict with those of the company?
- How might the behaviour of institutional investors be different from investors investing directly in shares on their own behalf?
- Should the company be concerned about social issues such as poverty in third world countries?
- What are the risks and rewards to the company of doing business in third world countries?
- What are the risks and rewards to shareholders of the company doing business in third world countries?
- How should the chairman respond to investor demands?

DIRECTORS' DILEMMA 6: SHOULD DIRECTORS ACT ON SHAREHOLDER DEMANDS?

Formulating a course of action

This sixth conflict-of-interest dilemma addresses issues concerning institutional investor conflicts of interest and the question of the exercise of power and who is in charge of the company. It is generally assumed that the interests of the company and those of its shareholders are aligned but this is not always the case. The non-alignment sometimes arises because the shareholder is the legal but not the beneficial owner of the shares. Institutional shareholders fall into this category. Managers working in institutional-shareholder organisations may have short term goals in terms of their next bonus, which may be in conflict with their investee companies and their clients. Boards and companies are required by law to have a longer term perspective. In relation to institutional shareholders managing pension monies, the ultimate beneficiaries, current and prospective pensioners, require a long-term perspective. This may be at variance with investment managers' next-bonus perspective. A further issue with this dilemma is the institutional shareholders' desire to dictate, expecting the directors to act on their instructions, and making threats if they do not.

Identification of key parties to the dilemma

There are two key parties to this dilemma:

- Chairman/directors of the board: The board has to be sensitive to the views of key institutional investors. The board needs to listen to and understand investor concerns. This dilemma highlights a problem of communication between a board and the shareholders. The institutional investors claim the company is being too conservatively managed, i.e., is too risk averse. The risk appetite of the company is likely to be lower than of the institutional investors who manage so many investments that they can diversify their risk in a way that the board cannot. The board has to set the risk appetite of the business, keeping in mind the needs of all shareholders and company survival. The board, through the chairman and/or managing director, need to clearly communicate the risk appetite of the business to the institutional shareholders to help them understand how the board arrived at such a risk appetite. The extent to which a board decides to follow philanthropic stakeholder-oriented activities is a judgement issue. A stakeholder-orientated approach is more difficult than a purely shareholder-orientated approach, as it involves trade-offs between stakeholder groups. Again, there might be dialogue with institutional shareholders to persuade them of the value from a long-term perspective of the third-world project. Finally, if the directors accede to the threat by the institutional managers, they cede power to that group. Who runs the company? It is important that the directors run the company, as they were appointed to do by the shareholders as a whole at the annual general meeting of the company. In the long-run, the board will garner more respect by not giving in to pressure arising from investment decisions driven by incentives.
- Institutional investors: Investment managers need a better understanding of the respective roles of shareholders and directors in corporate governance. They also need to recognise the conflicts between their personal interests, which are likely to be more short-term, versus the interests of the company for long-term success.

Legal regulations to be considered and any pertinent associated case law

The common law duty to look after the best interests of the company apply to directors, not shareholders. Shareholders appoint directors to the board to run the company. Directors have a duty to the company or to 'shareholders as a whole', not to individual shareholders or groups of shareholders such as institutional shareholders. If directors act on the wishes of a group of shareholders, and events subsequently take a turn for the worse, a claim that they were acting on shareholder wishes is unlikely to stand up in court, nor are the shareholders in such a situation likely to come to the defence of the directors.

Shareholders have a say in running the company and can express their views at annual and other general meetings of the company. Shareholders also have statutory decision-making powers including: approving at the annual general meeting dividends proposed by the directors, the financial statements, directors' report, auditor's report, electing the directors, appointing the external auditors, fixing the remuneration of the external auditor (normally the shareholders authorise the directors to fix the remuneration of the auditors), amending the memorandum and articles of association, calling an extraordinary general meeting, where shareholders holding more than 10% of share capital so request of the directors. Certain large transactions must also have to be approved by shareholders.

The law implicitly assumes shareholders will not do anything to harm their companies, as to do so would harm themselves.

DIRECTORS' DILEMMA 6: SHOULD DIRECTORS ACT ON SHAREHOLDER DEMANDS?

However, the law does not cater for shareholders who are not the ultimate beneficial owners of the shares.

Guidance from codes of best practice such as The UK Corporate Governance Code

Section E of *The UK Corporate Governance Code* deals with relations with shareholders. No distinction is made between different types of shareholder. However, institutional shareholders would be a key constituency. Main Principle E.1 requires a dialogue with shareholders based on a mutual understanding of objectives. The board is responsible for this dialogue taking place. While the Code recognises that the main point of contact for shareholders is the managing director and the finance director, the chairman has to ensure that views of shareholders are communicated to the board.

While The UK Corporate Governance Code sets out principles for effective boards, *The UK Stewardship Code*[31] sets out principles for effective stewardship by investors, particularly focussing on institutional investors. Principle 2 of the *Stewardship Code* requires institutional investors to have a robust policy on managing conflicts of interest which should be disclosed publicly. The policy should deal with identifying and managing conflicts of interest between the institutional investor and its clients/ beneficiaries, with the aim of taking all reasonable steps to put the interests of their clients/beneficiaries first. The policy should also address how matters are handled when the interests of the clients/beneficiaries diverge from one another. The *UK Stewardship Code* (2012) appears more focussed on conflicts of interest between institutional investors and their clients, whereas in this dilemma the conflict of interest is between the institutional investors and an investee company.

Application of ethical principles

The ICAS *Code of Ethics* advises professional accountants not to allow bias, conflict of interest or undue influence from others to override professional or business judgements, undermining objectivity.

DIRECTORS' DILEMMA 7: SHAREHOLDER'S CONFLICT OF INTEREST

The scenario

You are a board member of a non-commercial publicly owned company.

You know that as a director your duty is first and foremost to the company/shareholders as a whole, not to individual shareholders.

The Minister is, *ex officio*, the sole shareholder of the company.

He lives in BallyGoBackwards. His seat is marginal and the next election is looming. He has instructed the board that the publicly owned company is to move its headquarters to BallyGoBackwards which will generate much-needed employment in his constituency. This instruction has been approved by the government.

However, it is clear to the board that such a move would be very detrimental to the publicly owned company.

Question:

Should the board accede to shareholder instructions to move the headquarters of the publicly owned company to the Minister's constituency?

DIRECTORS' DILEMMA 7: SHAREHOLDER'S CONFLICT OF INTEREST

Analysis – issues to consider/debate

- How does the governance of publicly owned companies differ from the governance of, say, publicly listed companies?
- How are publicly owned company directors selected? How should they be selected?
- If invited to become a publicly owned company director, what would be the risks and rewards of holding such a position?
- What are the arguments in favour of/against the board acceding to the minister's request?
- What are the risks and rewards of moving the headquarters to the minister's constituency?
- Is the board conflicted in taking a decision on moving the headquarters to the minister's constituency?
- How would the board respond if this became a political scandal?
- How would the minister respond if this became a political scandal?
- What steps should the board take in protecting itself when taking the decision on this matter?

DIRECTORS' DILEMMA 7: SHAREHOLDER'S CONFLICT OF INTEREST

Formulating a course of action

This last of the seven conflict-of-interest dilemmas concerns a conflict of interest between the shareholder and the company. In Dilemma 6 the shareholder was an institutional shareholder. Here, a government minister is *ex officio* acting as shareholder. Similar to institutional shareholders and their clients/beneficiaries, government ministers may be the legal owner of the shares but citizens are the ultimate beneficiaries. The overriding key performance indicator for politicians is getting re-elected. Thus, government ministerial objectives include success in the next election. Citizens require the long-term success of publicly owned companies. Directors of publicly owned companies do not have quite the same freedom as private sector companies. The role of many publicly owned companies, particularly non-commercial publicly owned companies, is to implement government policy. Publicly owned company directors cannot do otherwise, even if they disagree with government policy. Before accepting a publicly owned company board appointment, prospective directors should be clear on the constraints involved.

Identification of key parties to the dilemma

There are two key parties to this dilemma:

- Minister (shareholder): The Minister is the shareholder of the publicly owned company, although it could be argued that the ultimate owners are the citizens. The Minister is expected to act in the citizens' interest. Gauging citizens' interests is not straightforward. Citizens' current interests may not be consistent with the long-term success of the publicly owned company. Citizens can express their approval or otherwise of the minister's and government's stewardship at each election. In this dilemma, the minister and the government have a conflict of interest between their wish for success in the forthcoming election versus the long-term interest of the publicly owned company.
- Board of directors: In this dilemma, the board is presented with a conflict of interest between its duty to look after the best interests of the company and its obligations to the shareholder who appointed the directors to the board in the first instance. Who runs the company? It is important that the directors run the company, which they were appointed to do by the shareholder. That said, having received an instruction from a government minister, endorsed by the government, does the board have much choice in the matter? As government ministers come and go, a 'Yes Minister' tactic might be to respond slowly to the ministers instruction.

Legal regulations to be considered and any pertinent associated case law

The common law duty to look after the best interests of the company apply to directors, not shareholders. The law assumes shareholders will not do anything to harm their companies, as to do so would harm themselves. However, the law does not cater for shareholders who are not the ultimate beneficial owners of the shares.

Guidance from codes of best practice such as The UK Corporate Governance Code

The requirements of the *UK Stewardship Code*[32] were discussed in Dilemma 6. The policy for dealing with conflicts of interest between institutional investors and their clients/beneficiaries is also required to address how matters are handled when the interests of the clients/beneficiaries diverge from one another. Although not directly applicable, the latter is relevant in this dilemma. Citizens in the minister's constituency will want the publicly owned company to move its headquarters to their constituency, but citizens elsewhere in the country may want the headquarters to be located in the best place for the company.

Application of ethical principles

Under the ICAS *Code of Ethics*, professional accountants are expected to act in the public interest. This standard of behaviour is also expected of politicians. The public (in the form of voters) have an opportunity at each election to judge whether the government and politicians have acted in such a manner. The problem, however, is defining what is meant by the 'public interest'. In addition, it is not clear whether voters take account of the public (national) interest versus their own local interests. Thus the phrase 'all politics is local'. Adhering to ethical principles, doing the right thing, is not always rewarded. This is why the application of ethical principles is so difficult in practice.

DIRECTORS' DILEMMA 8: POWER OF THE BOARD TO CONTROL BOARD PROCESS

The scenario

You are a non-executive director in a listed company. You have been supplied with a tablet by the executives to facilitate easy distribution of management papers electronically to fully brief board members in an efficient and environmentally friendly manner.

The executives are highly conscientious, making considerable efforts to ensure the board is properly briefed on all issues relating to the company's activities.

You notice since this initiative was introduced that board papers have been getting increasingly longer, with the last board pack delivered electronically running to over 1,000 pages of material.

Question:

Are there any issues in receiving board papers electronically via tablet?

DIRECTORS' DILEMMA 8: POWER OF THE BOARD TO CONTROL BOARD PROCESS

Analysis – issues to consider/debate

- Is being supplied with a tablet to facilitate easy distribution of management papers electronically in an efficient and environmentally friendly manner a positive or negative from the perspective of the non-executive directors?

- What are the security and confidentiality issues arising from supplying board members with tablets for board papers?

- Are there any data protection issues in supplying confidential board papers in this manner?

- Are directors and staff appropriately trained in the use and security of mobile technology?

- In what way could tablets be used to enhance the quality of individual board member performance prior to and at board meetings?

- In what way could tablets be detrimental to the quality of board meetings?

- Are board protocols required for electronic equipment in board meetings? If 'yes', what should the protocols be?

DIRECTORS' DILEMMA 8: POWER OF THE BOARD TO CONTROL BOARD PROCESS

Formulating a course of action

This dilemma concerns a matter of board process that potentially has implications for the common-law requirement for directors to exercise due care and skill in executing their duties.

Identification of key parties to the dilemma

There are two key parties to this dilemma:

- Board of directors: The receipt of information (and not just data) in the form of board papers in preparation for board meetings is critical for effective boards. Conscious of the information asymmetry risk for boards, efforts by management to fully brief directors have to be welcomed and encouraged. Electronic board papers are searchable by board members which could be very convenient.
- Managers: Provision of good quality information (not just raw unanalysed data) to the board is a duty of the managing director, her senior management team and managers generally.

Legal regulations to be considered and any pertinent associated case law

This dilemma is based on the Australian *Centro* case[33] in which the directors were found guilty of not exercising due care and skill. The case arose because of the misclassification in the financial statements of liabilities as long-term when they should have been classified as short term. The company went into liquidation shortly afterwards. The following evidence came to light during the Centro case:

- The board met monthly.
- Papers for meetings were voluminous (usually around 450 pages).
- Directors knew (or should have known) the bank facilities were short term, as this was indicated in two pages buried deeply in a 1,180 page board pack a number of months prior to the approval of the financial statements.

In arriving at his guilty judgement, the Centro judge observed:

- The volume of papers going to the board were within the power of the board to control.
- None of the non-executive directors had the practice of reviewing annexes to board papers.
- Directors assumed if the information in annexes was important it would be drawn to their attention by management at board meetings.
- Each director was aware (or should have been aware) of the short term debt.

Board responsibility for the financial statements is attested to by two board members, usually the chairman and managing director, having to sign the face of the income statement and balance sheet (statement of financial position). Responsibility for the financial statements is not one that directors can delegate. Approving the financial statements is a reserved function of the board.

Guidance from codes of best practice such as The UK Corporate Governance Code

The UK Corporate Governance Code makes the chairman responsible for information in the boardroom: The chairman is responsible for ensuring that directors receive accurate, timely and clear information'. The Code goes on to say 'Management has an obligation to supply such information'. This requirement may motivate managers to disclose a lot of information to avoid the risk of being accused of withholding information. The company secretary's pivotal role in ensuring good information flows is also identified.

DIRECTORS' DILEMMA 8: POWER OF THE BOARD TO CONTROL BOARD PROCESS

Application of ethical principles

Paragraph 310.1 of the ICAS *Code of Ethics* is relevant to this dilemma. Under the *Code of Ethics*, professional accountants in business should not lie to others, or intentionally mislead (including misleading by remaining silent). Occasionally swamping the board with irrelevant detail may be motivated by managerial obfuscation. It is known that obfuscation can be achieved by swamping people with lots of irrelevant detail which has the effect of hiding the key issues.

Other considerations – Technology and Gadgetry in boardrooms

Supplying board members with tablets may effect efficient and environmentally friendly distribution of board papers. However, there is a risk that the use of electronic means of distribution of board papers could lead to lengthier board packs. Board members are expected to read every page in their board pack. Is it wise for board members (especially non-executive board members) to facilitate distribution of lengthy board papers, given the legal risk of being found negligent in exercising due care and skill if they do not read every page in the board pack? Security may be an issue, with encryption of sensitive information required. Do board members need training in the use and security of mobile technology?[34] Does the technology allow board members to take notes as they do not have their papers in hard copy? There can be advantages in electronic distribution of board papers. Some boards use electronic methods to remotely track board members' interrogation of their board papers to ensure that all board members properly and fully prepare for board meetings. This suggests some distrust of board members.

The use of tablets and other such electronic devices to distribute board papers is convenient and practical. However, that convenience may encourage executives to provide so much information that board members are swamped and lose sight of the key high level issues the board should be addressing.

Should board members bring electronic devices such as tablets, laptops and smart phones to board meetings? Should board members and executives text-message, reply to emails and read day-job papers during board meetings? Or should they be listening carefully to what is being said at board meetings? Does technology and gadgetry enhance board meetings or are they a distraction? Boards should agree on protocols and chairmen may need to set the tone and standards of conduct concerning these issues.

Technology in boardrooms should be strictly controlled by chairmen who should clearly set the etiquette at the beginning of their tenure. A laissez-faire approach may result in board members not paying adequate attention at meetings. Written protocols, possibly in the board terms of reference, may be useful in making clear to directors the standards of behavior required.

Other considerations – How much is reasonable for directors to have to read before board meetings?

The following are extracts from the judgement in the Centro case which provide insights into how the courts might view the extent directors should read their papers.

> 6.160 In reaching my opinion I have also taken account of the fact that production of the annual financial statements was referred to as 'a massive project – 65 documents with 93 sets of complex financials at an average of 50 pages each equates to over 3,000 pages in total'. This is a huge amount of information for the members of the audit committee to read and understand and may make the failure to observe errors in the financial reports more understandable.
>
> 226. It was submitted by the non-executive directors that on no reasonable basis could it be suggested that the non-executive directors were required to scrutinize and cross check all of the papers and annexures provided to the Board each month in the sort of detail as ASIC [Australian Securities and Investment Commission] propound in respect of the Funding and Financial Risk Management submission ...
>
> 227. In relation to CER's [Centro Retail Group] debt, the non-executive directors submitted that ASIC relied solely on two pages of the CER 2007 Business Plan. Those two pages formed part of a Board pack of more than 1180 pages, provided in May 2007, and the information upon which ASIC relied was not referred to in

> the Executive Summary section of the CER 2007 Business Plan (which was itself a 72 page document). Nor was the information upon which ASIC relied covered in the presentation on the business plan delivered to the directors at their meeting in June 2007 …
>
> 229. In relation to this submission relating to the extent of the papers, I also make the following observations. A board can control the information it receives. If there was an information overload, it could have been prevented. If there was a huge amount of information, then more time may need to be taken to read and understand it. The complexity and volume of information cannot be an excuse for failing to properly read and understand the financial statements. It may be for less significant documents, but not for financial statements. As Mr Hullah [expert witness for the non-executive directors] accepts himself, the information was provided each month. The fact that information was provided in a different context does not detract from the fact that the directors were in possession of the information. The information was provided to the directors by management for a reason.

Other considerations – How much time should directors be expected to devote to their duties.

It is best practice for non-executive directors' letters of appointment to specify a time commitment. In turn, non-executive directors should undertake that they have sufficient time to meet the expectations of them.

Keasey and Hudson[35] recommend non-executive directors put aside two days a month to carry out their roles properly. Based on ten in-depth interviews, Acharya, Kehoe and Reyner[36] find that non-executive directors of publicly listed companies devote between 19 and 25 days a year to the job. For chairmen, the time commitment is significantly greater.

DIRECTORS' DILEMMA 9: CAN DIRECTORS RELY ON EXPERTS?

The scenario

You are one of four non-executive directors who sit with the managing director on the board of a listed company. The company was the first in its country to early-adopt International Financial Reporting Standards (IFRSs), commencing with its unaudited interim financial statements at 31 December 2005. The financial statements were approved by the board and signed off by the auditors on 6 March 2006.

At 31 December 2005, the company had £100 million of bank liabilities which it classified as long-term, even though technically-speaking the company had breached bank covenants which permitted the bank to call in the liabilities at any time. Two pages buried deeply in a 1,180 page board pack a number of months prior to the approval of the financial statements clearly showed that the bank facilities were short term.

The company went into receivership in September 2006.

The Regulator took an action against the directors on the grounds that:

i. the directors failed to comply with applicable financial reporting standards; and
ii. they failed to take all reasonable and proper steps to ensure that applicable financial reporting standards would be complied with.

The directors accepted the first charge.

In relation to the second charge, the directors argued that although the covenants had been breached, the bank had rolled over the loans in previous years and the directors therefore had a reasonable expectation that the bank would roll over the loans for another 12 months. In addition, they had relied on a qualified, competent, well-resourced financial management team, they had established a comprehensive transition process to IFRS Generally Accepted Accounting Principles and they had engaged a Big-Four audit practice to identify key areas and issues to be addressed in transitioning to IFRSs. A steering committee of the company's accounting staff and Big-Four audit practice staff had been put in place to review and ensure compliance with IFRSs. The Big-Four audit practice was engaged to review IFRS compliance and advise the board thereon. The managing director and financial controller had provided declarations of compliance with IFRSs to the board. There was a properly constituted audit committee. The audit committee meeting to review the interim statement commenced at 11.30 am and finished at 4 pm. At the audit committee meeting, the minutes recorded that the managing director had asked the Big-Four audit firm partner 'Can you assure me that these accounts comply with IFRSs'. The audit firm partner had responded 'yes'.

Question:

Have the directors breached their legal duty to exercise due care and skill by relying on experts?

DIRECTORS' DILEMMA 9: CAN DIRECTORS RELY ON EXPERTS?

Analysis – issues to consider/debate

- Why would a board early-adopt a completely new set of accounting standards in its unaudited interim statements?
- How should the board handle the issue of classification of bank liabilities?
- Why is the classification of bank liabilities so important?
- What are the implications if the bank liabilities are incorrectly classified?
- What are the implications for classifying the liabilities of the bank rolling over the loans in previous years?
- Had the directors a reasonable expectation that the bank would roll over the loans again, justifying classifying the liabilities as long-term?
- What reasonable and proper steps should the board have taken to ensure the new accounting standards were complied with?
- Are the steps taken by the board in relation to adopting a completely new set of accounting standards appropriate?
- Are the non-executive directors entitled to rely on the qualified, competent and well-resourced financial management team?
- Are the non-executive directors entitled to rely on declarations of compliance with IFRSs provided by the managing director and financial controller?
- What are the implications of the managing director having asked the audit firm partner about compliance and having received assurances that the company was compliant?
- If you were the judge, would you find the executive directors guilty or not-guilty of not exercising due care and skill and why?
- If you were the judge, would you find the non-executive directors guilty or not-guilty of not exercising due care and skill and why?

DIRECTORS' DILEMMA 9: CAN DIRECTORS RELY ON EXPERTS?

Formulating a course of action

This dilemma is loosely based on the New Zealand case, Feltex[37] and the Australian Centro[38] case (similar to Dilemma 8). The judgements in the two cases are referred to in this discussion. While Dilemma 8 is concerned with the availability of information and the exercise of due care and skill, this dilemma concerns whether directors can rely on experts and meet their common law duty to exercise due care and skill. While the Feltex directors were not found to have breached their common law duties, the Centro directors were found guilty of not exercising due care and skill and their defence that they relied on experts was not accepted by the judge.

Identification of key parties to the dilemma

There are three key parties to this dilemma:

- Board of directors: This dilemma illustrates the risks of being a non-executive director. Those on the board are the responsible parties. Whether the directors are ultimately found guilty or not (and the eight Centro defendents were found guilty), they will have suffered severe reputational damage by virtue of being the subject of prosecution by the Regulator. The board early-adopted International Financial Reporting Standards in the interim financial statements which were not audited. A transition process to these new standards was adopted.
- Finance staff: The finance staff have a duty to properly brief the board. Failure to adequately draw the board's attention to the two pages buried in the board pack a number of months previously was negligent on their parts. But finance staff, other than the chief financial officer, were not taken to court. Australian regulators have recognised this problem.[39] The worse that can happen to the finance staff is that they lose their jobs and they may also suffer reputational damage. Were the finance staff aware that the financial statements were misleading? If the finance staff were not aware, were they competent? If the finance staff were aware, why did they not inform the board?
- External auditors: The risk for external auditors is a legal claim for negligence. The external auditors settled the Centro case for AU$200 million. The Australian Securities and Investment Commission (ASIC) banned the audit firm partner from conducting audits for two and a half years until 2015.[40]

Legal regulations to be considered and any pertinent associated case law

Case law on the exercise of due care and skill is relevant to this dilemma. Directors are entitled to rely on persons to whom business has been delegated. Directors can delegate tasks to others but they cannot delegate their responsibility for the proper execution of those tasks. Further, if directors delegate to others, they must only delegate to persons with integrity and who have the skills and competencies for the task.

The case *ACIS v Adler & Ors*[41] sets out 15 summary propositions/principles applicable to directors in exercising their duty of care and diligence in delegating tasks to others.

Those relevant to this dilemma include requirements for directors:

- To be familiar with the fundamentals of the business.
- To have a continuing obligation to keep themselves informed.
- To regularly attend board meetings.
- To be familiar with the financial status of the company, including regular review of the financial statements.
- To rely without verification on the judgement, information and advice of management, except where reliance would be unreasonable as the directors know, or by the exercise of ordinary care should have known, any facts that would deny reliance on others.
- In determining whether delegation is reasonable, to consider:
    - o whether the function delegated is appropriate for delegation;
    - o the extent to which the director is put on inquiry;
    - o whether they honestly believe that the delegate is trustworthy, competent and someone on whom reliance can be placed;

- o the nature and risk of the transaction;
- o the steps taken by directors, enquiries made concerning engendering of trust; and
- o whether the director is executive or non-executive.

At the heart of this dilemma is the question of whether directors can rely on the work and advice of company managers, external accountants and auditors when approving financial statements. In the *Jagwar Holdings Limited v Julian Holdings*[42] case, even though the directors had not checked the calculations themselves, the judge found that they had exercised reasonable care in relying on the financial controller in preparing a financial forecast and on the review of that forecast by a Big-Four audit practice. While acknowledging that directors have only limited obligations to search out information, they must pay attention and give appropriate consideration to matters placed before them. If directors cannot delegate to managers in a position of trust, it would render the conduct of business impossible. However, the growing desire of courts to limit directors' ability to wash their hands of obligations to intelligently oversee company affairs was noted.

In relation to delegation of duties, it has been observed that directors ' … are entitled to impose trust in others so long as they take reasonable steps to ensure that such trust is warranted and are not alerted to reasons why the trust may be misplaced'.[43]

On the question of whether the directors could rely on professional expert advice or whether they had to do it themselves, the Feltex judge observed that:

- IFRSs are highly complex and presume an in-depth knowledge of accounting principles.
- Those applying IFRSs, and advising on IFRSs, have undergone specialist training.
- Interpreting and applying IFRSs requires highly specialist expertise in an already specialised field.
- Specialist auditors look to specialist technical experts in their firms for advice on interpreting and application of IFRSs.

The judge in the Centro case was acutely conscious of the findings in the Feltex judgement, and extensively referred to that case in his judgement. The Centro judge agreed that 'it cannot be denied that directors have been and are entitled to rely upon specialist advice' and that the directors should not have done it all themselves, nor do they have to become familiar with the complexities of various accounting standards. He acknowledges that the individual circumstances of a case may lead to different conclusions. What is encompassed by taking all reasonable steps will differ depending upon the company, the nature of its business and its complexity. What the Centro judge appears to have placed more emphasis on is the prior knowledge of the directors from earlier board papers that should have alerted them to the incorrect accounting classification of current liabilities as non-current: 'The significant matters not disclosed were well known to the directors, or if not well known to them, were matters that should have been well known to them'.

To a non-lawyer, these two judgements appear quite contradictory. The Feltex judgement is strong in its finding that directors are entitled to rely on experts, such as finance staff in the company, external accountants and external auditors. The judgement concludes that it would be unreasonable and unworkable to expect directors to be experts in accounting standards which are lengthy and highly technical. Conversely, the Centro judgement concludes that directors cannot rely on the advice of management in place of attending to and examining themselves important matters such as their financial reporting obligations which fall firmly within their board responsibilities.

These legal conflicts leave company directors in a confusing and unsatisfactory position. What is clear from these two cases is that the expectations of directors on the execution of their duties is all the time increasing. No person should take on a directorship without understanding the very significant risks of such a position. Once appointed by the shareholders, directors cannot afford to leave any stones unturned in terms of understanding the business right down to the small print and technical knowledge of fine details.

Guidance from codes of best practice such as The UK Corporate Governance Code

The companies in this dilemma, Centro and Feltex, appear to have complied with corporate governance best practice requirements, such as articulated in *The UK Corporate Governance Code*. Thus, while compliance with such codes is an indicator of good governance, it does not guarantee good governance.

DIRECTORS' DILEMMA 9: CAN DIRECTORS RELY ON EXPERTS?

Application of ethical principles

If, as is conjectured earlier, some staff knew that the financial statements were misleading, withholding this information from the board would be an ethical issue. Paragraph 110.2 of the ICAS *Code of Ethics* requires professional accountants not to knowingly be associated with reports, returns, communications or other information where the professional accountant believes that the information:

- contains a materially false or misleading statement;
- contains statements or information furnished recklessly; or
- omits or obscures information required to be included where such omission or obscurity would be misleading.

DIRECTORS' DILEMMA 10: EARNING SIGNIFICANT PROFITS

The scenario

You are a non-executive director in a financial services company.

The company has experienced great success and has earned significant profits through lending assets in unit-linked funds to borrowers, in return for substantial fees to the company. The fees are so significant that they more than compensate the company for any credit risks being taken.

Question:

As a non-executive director, how would you react to management's successful revenue generating initiative?

DIRECTORS' DILEMMA 10: EARNING SIGNIFICANT PROFITS

Analysis – issues to consider/debate

- As a non-executive director, are you happy with the company's profitability?
- What are the risks and rewards in relation to the arrangements described in this dilemma?
- To what extent might personal motivations be relevant in this dilemma?
- Are there any regulatory issues that need to be considered?
- What are the implications of this dilemma for the composition of the board?
- What additional information should the board request in this matter?

DIRECTORS' DILEMMA 10: EARNING SIGNIFICANT PROFITS

Formulating a course of action

'All that glitters is not gold'. The relationship between risk and reward is well known. While it is tempting for boards to be pleased with substantial profitability, we know from the banking crisis in 2008 that substantial profits may be earned by taking excessive risks. The board needs to clearly understand the risk-reward relationship. To do this properly, the board needs to look 'under the bonnet' and see what is really going on in the engine of the business. It is a difficult judgement for non-executive directors to know how much depth they should go into, and how to avoid confusing governance and day-to-day management. Internal audit can be a useful resource to make in-depth enquiries under direction of the audit committee, on behalf of the board.

Identification of key parties to the dilemma

There are two key parties to this dilemma:

- Non-executive directors: Non-executive directors need to understand with forensic clarity the company's business model (i.e., how the company preserves value over the longer term), including the risks being taken to generate the significant profits. They need to be confident that they fully understand the risks being taken, and that the risks being taken are within the risk appetite for the business. Unit-linked funds usually come into existence by virtue of a prospectus which contains the terms and conditions for investing the assets in the fund. Alternatively, sale of the unit-linked funds may involve contractual agreements with customers. The board should request internal audit to check whether lending assets of the fund to borrowers is permitted under the prospectus (mutual funds)/sale contracts (individual customers). The profit-making activities should not be *ultra vires* – outside the powers of the company. *Ultra vires* decisions or actions outside company powers are void and unenforceable. Given the nature of the business – financial services – in which sector significant problems have come to light concerning mis-selling, the board needs to be sure that transactions with customers/borrowers comply and are seen to comply with consumer legislation and guidelines. In this respect, the board might request the internal auditor to examine the customer complaints file and might obtain a briefing from legal counsel on any litigation or threatened litigation against the company from customers. The board needs to be satisfied that the remuneration policies, in particular the incentives, are not motivating staff to take greater risks than those suitable to the risk appetite of the business. Finally, internal controls around administration of the unit-linked funds may also need to be examined to ensure unit-linked funds are ring-fenced from the company's own assets. The board might also request sight of reports and correspondence between the company and the regulator.
- Executive directors and management: In financial services, regulatory obligations are particularly onerous. There may be implications for managers if issues of non-compliance or irregularities come to light. Managers may lose their jobs and be subject to regulatory sanctions.

Legal regulations to be considered and any pertinent associated case law

Under powers derived from the Financial Services and Markets Act 2000, the Financial Conduct Authority and the Prudential Regulatory Authority regulate the financial services industry in the UK. The board will need to ascertain whether the transaction itself – lending to borrowers – is authorised by the Regulator. Certain persons carrying out duties of a governance nature are identified as 'control functions'. Persons holding control functions must be authorised by the Financial Conduct Authority. Directors of financial service companies are control functions which must be authorised. The Financial Conduct Authority will only authorise a person who is 'fit and proper' to perform the control function. The Financial Conduct Authority has extensive powers of enforcement. Firms, executives and directors breaching consumer legislation requiring fair treatment of customers may be subject to sanctions.

Guidance from codes of best practice such as The UK Corporate Governance Code

Following the 2008 global financial crisis, revisions to The UK Corporate Governance Code have placed more emphasis on the requirement for directors and shareholders to understand their company's business model (i.e., how the company preserves value over the longer term). For example, code provision C.1.1 requires directors to provide the information necessary for shareholders to assess the company's performance, business model and strategy in the annual report. Under code provision C.1.2, directors are required to explain the basis whereby the company generates or preserves value over the longer term. Further, under the UK Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013, companies are required to include a strategic report in their annual reports. The strategic report must address the company's business model, strategy, development, performance, position and future prospects. Guidance on matters to be considered in preparing a strategic report and explaining the business model are provided by the FRC.[44]

The UK Corporate Governance Code (2012, p. 26) recommends that remuneration incentives be compatible with risk policies and systems.

Application of ethical principles

The ICAS *Code of Ethics* observes that a distinguishing mark of the accountancy profession is its responsibility to act in the public interest. This involves having regard to the legitimate interests of a wide group of people, including investors. The *Code of Ethics* points out that a professional accountant's responsibility is not just to the needs of an individual client or employer.

In this dilemma, if it transpires that professional accountants did not comply with the terms of the prospectus/contracts with investors/customers and/or engaged in mis-selling, they may have breached the ICAS *Code of Ethics* fundamental principle to behave with integrity. This involves being straightforward and honest in professional and business relationships. It also implies fair dealing and truthfulness by the professional accountant. Under the *Code of Ethics*, a professional accountant's work must be uncorrupted by self-interest and not be influenced by the interests of other parties.

DIRECTORS' DILEMMA 11: REDUCING THE WORKFORCE

The scenario

You are a non-executive director on the board of a company that employs a large number of staff. The company has a particularly strong track record as an excellent employer. This has contributed to its high standing and reputation in the business community.

The economy is in deep recession, and business profitability has suffered considerably. The weakening financial performance of the company may threaten the financial stability of the organisation.

One way around the financial problems of the company is to make a substantial part of the workforce redundant. In order to maintain profitability, management is bringing a proposal to the board to permanently reduce the workforce.

In addition, you hear from a contact in the organisation that, in the interests of shareholder returns, the company has a standard practice of adopting certain tactics to provoke more expensive long-serving staff in their 50s into leaving the company, and replacing them with less-expensive younger staff in their mid-30s. As a result, the company has been consistently profitable over many years.

Question:

As a non-executive director could you support: (i) making a substantial part of the workforce redundant; and (ii) the approaches taken to cost-efficient management of the workforce?

DIRECTORS' DILEMMA 11: REDUCING THE WORKFORCE

Analysis – issues to consider/debate

- How should boards/board members handle hearsay?
- Should making a substantial part of the workforce redundant be supported?
- What are the risks and rewards of making a substantial part of the workforce redundant?
- What challenging questions would you ask of management at the next board meeting?
- What additional information should the board request in this matter?
- Are there any conflicts of interest for directors in relation to this decision?
- What advice should be obtained in relation to this proposal?
- What ethical issues should the board consider in relation to this decision?
- How should the communications process be handled around this event?
- How should the board exercise oversight in the event that the board ratifies management's proposal?
- Is the practice of provoking long-serving staff into leaving consistent with the objective of the company to make a profit for its shareholders?
- Are there any reputational risks for the company arising from the apparent treatment of long-serving staff?
- What are the legal issues concerning the alleged treatment of long-serving staff?
- What challenging questions would you ask of management in relation to the alleged treatment of long-serving staff?
- What additional information should the board request in relation to the alleged treatment of long-serving staff?
- To what extent is the alleged treatment of long-serving staff a management issue versus a governance/board issue?

DIRECTORS' DILEMMA 11: REDUCING THE WORKFORCE

Formulating a course of action

Looking after the best interests of the company may require directors to take some tough decisions in the interest of company survival. Under a stakeholder model of governance, boards are expected to take account of the interests of stakeholders, including employees, as well as those of the company. It can be difficult for boards to trade-off the interests of the company/ shareholders as a whole and those of employees. This is at the heart of this dilemma.

Identification of key parties to the dilemma

There are three key parties to this dilemma:

- Board of directors: In a shareholder value model of corporate governance, the dominant consideration for board decisions is shareholder value. In a stakeholder model of corporate governance, other stakeholders such as employees would be actively considered by the board. The number one duty of the board is to ensure company survival. The board must ensure that the company operates in a manner that does not put the survival of the company at risk. Not making roles/ employees redundant could be a risk to the organisation. Next, the board has to consider shareholder value and the trade-offs to make in relation to shareholders versus other stakeholders such as employees. In judging the management proposal, the board has to examine whether there are alternatives to addressing profitability issues/cutting costs other than making roles/staff redundant, the risks to the business arising from a reduction of the workforce, the threats to the business in making a large number of roles/staff redundant and the threats to the business from individual staff to be made redundant. Are there other ways to cut labour costs such as part-time or short-time working, week on/week off, no overtime, cessation of temporary/agency staff, salary cuts, pay freezes? The board needs to critically evaluate any financial projections included in the management proposal, challenging any assumptions underlying forecasts and projections. Is the business case comprehensive and credible? The board will need to critically examine the costs and benefits of the proposal, ensuring that all costs are factored into the decision. The long-term consequences of the decision need to be assessed, including examining the positioning of the company in the event that business picks up when the economy comes out of recession. Is it a voluntary redundancy scheme? Is there a risk of losing key staff? The board also has to consider whether management, particularly the human resources section, has the expertise and experience to handle a significant redundancy programme. The board needs to assure itself that the processes and procedures to be adopted in making staff redundant is fair and equitable. Individual board members may be subject to lobbying by staff on such a sensitive proposal. Board members need to be clear on their role as governors and high-level decision makers as distinct from the day-to-day operational roles of executives. The board and management will have to have a communications plan in place to handle PR and media enquiries. In relation to the practice of getting rid of older staff, as this is likely to be illegal, the board needs to obtain the facts to corroborate the hearsay in the dilemma. Internal audit might be requested by the board (through the audit committee) to conduct an investigation of the issues raised. The findings of the audit committee will influence how the matter is then handled. Until the issue is bottomed out, this matter entails legal and reputational risks for the company. The alleged systematic practice of getting rid of older staff, were it known publicly, would likely cause reputational damage to the company. In addition, there is a risk that this practice could lead to expensive high profile litigation from employees affected. This could also attract adverse media attention.
- Management: If the board supports management's proposal, execution of the board's decision needs to be handled extremely sensitively. The approach taken will be influenced by whether the workforce is unionised. If there is a union, a great deal of dialogue and negotiation will be required at that level. It is essential that the processes and procedures management put in place are, and are seen to be, fair and equitable.
- Employees: Employees will consider their own rights, in terms of job security and redundancy entitlements. They may seek legal advice. They may litigate. They may use their power position to make laying off staff difficult for the company. If the company is unionised, employees may look for and obtain support from that source.

Legal regulations to be considered and any pertinent associated case law

Section 172 of the Companies Act 2006 requires boards to promote the success of the company. In so doing, directors are required to have regard to six, what are called 'enlightened', shareholder value factors (see Chapter 2). One of these is to have regard to the interests of the company's employees. This duty, however, is owed to the company alone. For this reason, employee interests are subsidiary to those of the company.

DIRECTORS' DILEMMA 11: REDUCING THE WORKFORCE

Legislation concerning employees is highly relevant to this dilemma. The board needs to be familiar with the legal requirements, and the consequences for the board, individual board members and the company of not complying with the legal requirements. It is likely that the alleged systematic practice of letting go of older staff breaches employment equality legislation. It is beyond the scope of this report to delve more into these legal requirements.

Guidance from codes of best practice such as The UK Corporate Governance Code

The role of the board in setting the high level values and standards for the company is emphasised in *The UK Corporate Governance Code*. In this respect, the Code makes it clear that these obligations are to shareholders 'and others', implying a stakeholder model of governance in the UK. The Code does not elaborate further.

Application of ethical principles

Under the ICAS *Code of Ethics*, professional accountants take on a responsibility to act in the public interest. Acting in the public interest involves, *inter alia*, having regard to the legitimate interests of employees. The public, including employees, rely on the objectivity and integrity of the accounting profession to support the propriety and orderly functioning of commerce. The alleged systematic practice in this dilemma of letting go of older longer-serving staff, if proven to be true, arguably breaches these standards.

Another ethics question is what measures are the managing director and senior managers taking personally to sharing the pain or is the cost cutting focussed only on the less-well paid in the company?

DIRECTORS' DILEMMA 12: REMOVAL OF A SENIOR MANAGER

The scenario

At a recent audit committee meeting of a very large beverages distribution company, the internal auditor reported that, following a thorough investigation, the warehouse manager, who has been an exceptional employee of the business for over 20 years, was caught on close-circuit television taking a single bottle of the wine from the company's inventory in the warehouse on Christmas Eve.

The managing director, who has never got on with the warehouse manager, wishes to remove the manager.

Question:

Should the warehouse manager be dismissed for removing a single bottle of wine from the warehouse?

DIRECTORS' DILEMMA 12: REMOVAL OF A SENIOR MANAGER

Analysis – issues to consider/debate

- What challenging questions would you ask of management in relation to this issue?
- What additional information should the board request in this matter?
- Why should the warehouse manager be dismissed/not dismissed?
- Is this a management or a board issue?
- What policies, processes and procedures should the company have in place to protect it in this matter?
- What legal considerations should be taken into account in this matter?
- If, instead of taking a bottle of wine, the manager stole £15 cash, would your views on this dilemma be different?

DIRECTORS' DILEMMA 12: REMOVAL OF A SENIOR MANAGER

Formulating a course of action

This dilemma involves a transaction of miniscule value – a bottle of wine. Is a transaction of such small value deserving of a dilemma? Or are there higher-order principles that are so important that the value of the transaction is irrelevant? These considerations are what this dilemma is all about.

Identification of key parties to the dilemma

There are five parties to this dilemma.

- Audit committee: As this is the subject of an internal audit investigation it has in the normal way come before the audit committee as part of its role on behalf of the board in overseeing the work of the internal auditor. However, given the poor relations between the managing director and warehouse manager, the audit committee must question what triggered the investigation. Is it driven by the managing director's personal vendetta? The audit committee has to question whether this is a governance or day-to-day management issue. While there is a strong argument that this is a day-to-day management issue, the audit committee may need to oversee its handling by management because of the potential reputational risks if the matter becomes public and the litigation risks if the matter goes to court. The incident may also be important in setting the tone at the top. How would the theft of a bottle of wine by a junior employee be treated? Should there be the same treatment at the highest level in the organisation as well as at the bottom of the organisation? On the other hand, dismissal of an exceptional senior employee of 20 years' service may be heavy handed.
- Board of directors: The board of directors should ensure that management has a robust code of conduct for staff in place, together with a robust policy on fraud, which the board should oversee.
- Internal auditor: As the litigation risk is high, the internal auditor needs to be confident that the investigation is conducted to the standards required in criminal proceedings (i.e., evidence beyond reasonable doubt) and that the investigation has been conducted in a fair and reasonable manner. Is close-circuit television evidence admissible in disciplinary proceedings against an employee? In a similar case (involving more significant amounts), after a lengthy hearing in the Employment Appeals Tribunal which was appealed to the Circuit Court, notwithstanding that misappropriation was caught on close-circuit television, the court awarded the plaintiff €200,000 in damages, because of the conduct of the internal audit investigation.[45]
- Managing director: The implication that the dismissal is motivated by bad personal relations is of concern. It is essential for a managing director to act in a manner that is, and is seen to be, impartial, fair and equitable to all employees.
- Warehouse manager: If the warehouse manager was as effective as is suggested by the wording in this dilemma ('exceptional manager'), he would have had in place effective inventory management systems including a tough stance on inventory security. The standard of behaviour has to be the same or better for staff at the top as well as at the bottom of organisations. Senior staff should lead by example. Therefore, the warehouse manager's behaviour has to be judged by the standards she applied to others. Were other members of staff permitted to take a bottle of wine home at Christmas? Staff pilferage can be a pervasive problem in business. Some businesses have a policy on 'shrinkage' (a euphemistic term!). Does such a policy legitimise theft?

Legal regulations to be considered and any pertinent associated case law

A purist might characterise the taking of a bottle of wine as theft or fraud. There is no evidence that any other stock has gone missing. Companies have obligations to report suspicions of fraud to the authorities. However, reporting such a small incident to the authorities is likely to be seen by them as disproportionate.

If the warehouse manager's employment is to be terminated, her employment contract needs to be examined, as will company policies on the misuse of assets, evidence that company policies had been brought to the attention of the warehouse manager and evidence that the policies have been applied consistently by the company since being adopted. The courts have not looked favourably on employees who have clearly breached company policy even where the amounts involved were miniscule.[46]

Guidance from codes of best practice such as The UK Corporate Governance Code

Supporting principle A.1 of *The UK Corporate Governance Code* requires boards to set the company's values and standards. While the theft of a bottle of wine is miniscule in value, its implications for the company's values and standards are arguably more significant. Under code provision C.2.1, the board is required to maintain sound internal control systems. As part of maintaining sound internal control systems, the company would be expected to have a written fraud policy in place. The purpose of such a policy is to set the tone at the top, to deter fraud by making sure all employees will be prosecuted when fraud comes to light (i.e., fraud will not be brushed under the carpet), to protect staff so that they clearly know without ambiguity the company's attitude to fraud and the consequences for them of being found to have engaged in fraud, steps open to employees when they have concerns about wrongdoing, setting out how fraud will be investigated to protect staff by means of fair and equitable procedures and to ensure the investigation is robust from a legal perspective.

Application of ethical principles

Tenbrunsel and Messick[47] capture the heart of this dilemma nicely when they speak about the 'slippery slope' of decision making, for example, processes that re-label something without ethical considerations (e.g., 'taking' versus 'theft of'' a bottle of wine) and incremental steps which hide the ethical implications of decisions. From this may follow 'If what we were doing in the past was OK and our current practice is almost identical, then it too must be OK'. Similarly, in an external auditing context, Bazerman, Loewenstein and Moore[48] talk about concealment of minor indiscretions which, when repeated in the future, can end up as major frauds. They call adapting to small imperfections, with the sum of these judgements becoming large, 'escalation'.

The board has to ensure that principles of fairness and equity are followed – there is a suggestion otherwise in the dilemma when it refers to the antipathy of the managing director towards the warehouse manager. Due process should be followed, with procedural fairness, including the presumption of innocence until proven guilty. The sanction should fit the crime.

DIRECTORS' DILEMMA 13: STAFF INVENTORY

The scenario

You are a non-executive director in a large publicly listed multinational company in the drinks business.

You hear for the first time from an employee (a relative) that significant amounts of inventory in the organisation are unaccounted for. While the amounts are significant, they are not material from a financial reporting point of view. It is widely accepted that staff surreptitiously remove goods on a regular basis. Further, your informant tells you that a 'blind eye' is turned to this by management, who acknowledge that this long-standing practice is an accepted norm that has developed over many years.

The company has had a history of very damaging industrial relations arising from employees being members of a powerful union. The managing director advises that if this matter is challenged by management, the whole workforce is likely to go out on strike. The strike is likely to be protracted, and to cause significant reputational damage to the company, including significant loss of custom.

Question:

Should the board ignore staff pilferage in favour of harmonious industrial relations?

DIRECTORS' DILEMMA 13: STAFF INVENTORY

Analysis – issues to consider/debate

- How should boards/board members handle hearsay?
- What are the implications for the company in turning a blind eye to the staff pilferage?
- Can the board turn a blind eye to the staff pilferage?
- To what extent does the information that the amounts involved are not material make a difference?
- As a board member, how would the threat of industrial action influence your views?
- What steps should you take in relation to the information that has come to your attention?
- What are the implications of hearing that this practice has been going on for a very long time?
- Who in the organisation is responsible for this issue?
- What steps should the board take in relation to this information?

DIRECTORS' DILEMMA 13: STAFF INVENTORY

Formulating a course of action

Similar to Dilemma 12, this dilemma involves inventory. In Dilemma 12 the amount involved was miniscule. Dilemma 12 shows how a lax attitude can result in practices escalating such that they ultimately become both significant and difficult to control. In many businesses, the security of inventory is a challenge, particularly consumable or easy-to-sell-on-the-black-market inventory. Employee theft of inventory is not uncommon. Companies, therefore, need to have in place robust policies protecting the company from fraud and protecting employees from the temptation of fraud. This requires a fraud policy, a code of behaviour and a determined approach to prosecute fraud as a deterrent to future fraud.

Identification of key parties to the dilemma

There are three key parties to this dilemma:

- Board of directors: While the issues in this dilemma are not material from a financial reporting point of view, they arguably are material from a tone at the top perspective. If the board has put down strong markers concerning tone at the top issues, it will be of concern to the board that management is not implementing these standards in relation to the security of inventory. It might also be of concern to board members that they were not made aware of the problem concerning staff inventory until a relative/whistleblower drew a director's attention to the problem. The board might then wonder are there other significant issues of which it is unaware. It should also be of concern to the board that an issue of honesty and integrity is being undermined by the attitude of the union, at least according to the managing director. The claim/threat that the workforce will go out on strike needs to be challenged. The board has to question why the union has acquired such power. Is management not competent in dealing with the union? As part of the external audit, board members are required to make representations to the external auditors *inter alia* concerning their knowledge of fraud in the organisation. The board will have to bring the staff pilferage to the external auditor's attention who, in turn, may be required to report this externally as fraud is a criminal offence. There is also the question of benefit-in-kind taxation liabilities which, if not paid by employees, may become a liability of the company.
- Management: Management are required to implement an effective internal control system. Consequently, management has to address the inventory security issue and to resolve the internal control weakness. Management also has to manage the relationship with the union ideally appointing someone with good negotiation and communication skills to work on this project and to resolve the internal control weakness. In moving to regularise the matter and resolve issues with the union, management may consider introducing some kind of controlled official staff purchases system whereby staff get company product at preferential rates.
- Trade union/employees: The threat (according to the managing director) from the trade union to go out on strike if the company tightens up its inventory security and management processes is unethical, if true. Dialogue needs to take place to educate the trade union on the responsibilities of directors concerning systems of internal control. Because pilferage has been going on for so long, staff possibly view it as an entitlement of their position and part of their pay package. That the company allowed the practice to go on for so long, implicitly condoning the practice by taking no action, might provide employees with a sense of entitlement. There are risks to employees of these practices. Significant pilferage could put jobs at risk by reducing the profitability of the company.

Legal regulations to be considered and any pertinent associated case law

The apparent removal of company goods by employees, if proven, is fraud. However, proving fraud to the standard of criminal evidence can be difficult. Investigating the fraud has to be done in such a manner that the evidence will stand up in an employment appeals tribunal and in court. Therefore, the company has to proceed with caution and with the assistance of a good lawyer.

Guidance from codes of best practice such as The UK Corporate Governance Code

Under code provision C.2.1 of *The UK Corporate Governance Code*, the board must at least annually review the effectiveness of the system of internal controls and report to shareholders that they have done so. Guidance on how to conduct the review of internal control effectiveness is provided in what is called the 'Turnbull Report'.[49] That significant amounts of inventory are unaccounted for suggests the board may have difficulty in stating that an effective system of internal controls is in place. The dilemma mentions that the amounts involved are not material. Materiality is a concept in accounting and auditing, crudely speaking, concerning the level of accuracy/margin of error in the annual financial statements. The distinction between 'significant' and 'material' in this dilemma is that the unaccounted for inventory is not such a large error as to prevent the financial statements from showing a 'true and fair view'. However, a significant material error has implications for the board's review of the effectiveness of internal financial controls.

Application of ethical principles

The apparent removal of goods surreptitiously on a regular basis suggests an ethical problem among staff. A code of conduct for employees should be in place setting out the company's expectations concerning staff behaviour. A training scheme needs to operate on a regular basis to ensure staff are familiar with the Code and regularly reminding staff of its provisions.

Other considerations

Benefit-in-kind taxation issues may be relevant to this dilemma.

DIRECTORS' DILEMMA 14: EXECUTIVE REMUNERATION

The scenario

You are a non-executive director and chairman of the remuneration committee.

The managing director has done such a good job over many years that his name is closely associated with the brand of the company. The managing director is also a significant shareholder and holds considerable intellectual property knowledge. He has circulated his proposals concerning his bonus and remuneration of his senior management team for the year, to be considered at the forthcoming remuneration committee meeting.

The managing director has pursued a very aggressive revenue growth strategy, together with multiple acquisitions. The bottom line for the year is looking very healthy.

However, you are concerned at the huge remuneration amounts including bonuses proposed.

You have heard of a professional who runs a remuneration consulting business and who is well known for taking a robust line, and for having a very shareholder-sensitive perspective.

You mention to the managing director that you are considering taking independent advice from the remuneration consultant. The managing director is furious, suggesting that you are trying to undermine his authority with his senior management team and threatening to go elsewhere. He indicates that his stellar performance at your company has attracted the notice of other businesses who have been trying to head hunt him, offering him significantly greater remuneration than on offer this year.

Question:

Should the board/remuneration committee hire the independent remuneration consultant to advise on the managing director's and senior management's remuneration?

DIRECTORS' DILEMMA 14: EXECUTIVE REMUNERATION

Analysis – issues to consider/debate

- Is the managing director's performance in managing the company appropriate?
- Is the managing director's bonus proposal appropriate?
- Are the managing director's proposals for the senior management team remuneration appropriate?
- Is the managing director's fury concerning taking advice from independent remuneration consultants appropriate?
- Are the managing director's threats appropriate?
- How should the chairman of the remuneration committee handle this matter at board level?

DIRECTORS' DILEMMA 14: EXECUTIVE REMUNERATION

Formulating a course of action

This dilemma concerns a common problem in governance – the distribution of power between various parties. In this dilemma, the power play is between the board, the chairman of the remuneration committee and the managing director. The appropriateness of a managing director making threats to a board such as in this instance the threat to move elsewhere is problematic for the board. Who is in charge? Is the board a legal fiction, *de jure* (i.e., in law) responsible for the company but *de facto* (i.e., in practice) not? If the board concedes to the managing director's threats, what would be the longer-term consequences of the ceding of power from the board to the managing director? An additional aspect of the dilemma is the payment of huge remuneration to the managing director and senior managers.

Identification of key parties to the dilemma

There are three key parties to this dilemma:

- Board of directors/chairman of the remuneration committee: The board of directors is responsible for remuneration of the managing director and to a lesser extent senior managers. The board of directors will have to be able to justify the pay package of the managing director and senior executives to shareholders at the annual general meeting. Arguably, the shareholders appointed the board, especially the independent non-executive directors, to look after shareholders' interests which *inter alia* includes using shareholders' monies appropriately in paying senior staff. Executive director pay is disclosed in the annual report which will be read by shareholders, employees and the general public. The pay package for the managing director sets a tone for the company and makes a statement about the values of the company.
- Managing director: The managing director's wish to be compensated in 'huge' amounts may be revealing about the managing director's personality, his instinct for money and his greed. Managing director greed and love of money can be a risk to companies.
- Remuneration consultant: *The UK Corporate Governance Code* specifies that appointment of remuneration consultants is a responsibility of the remuneration committee. The Code requires remuneration consultants to be identified in annual reports and disclosure made as to whether they have any connection with the company. Clearly, the Code is concerned that remuneration consultants should be independent. The remuneration consultant described in this dilemma is a rare breed – a truly independent advisor with the shareholders' interests at heart.

Legal regulations to be considered and any pertinent associated case law

There are no laws concerning the quantum of executive remuneration. The law requires remuneration of directors to be disclosed in the financial statements. The detailed disclosure requirements for listed companies are beyond the scope of this report.[50] In addition, under Section 439 of the Companies Act 2006, listed companies are required to table non-binding advisory say-on-pay votes at their annual general meetings. While results of the vote are not binding on the company, they can be persuasive. The UK government introduced a requirement for companies to have their remuneration policies approved by shareholders at least every three years in the Enterprise and Regulatory Reform Act 2013. All remuneration payments must be made under an approved policy.

Guidance from codes of best practice such as The UK Corporate Governance Code

A fundamental principle of The *UK Corporate Governance Code* is that no director should be involved in deciding his or her own remuneration.

Section D of *The UK Corporate Governance Code* provides that remuneration should be sufficient to attract and retain but a company should avoid paying more than is necessary. A significant portion of executive remuneration should be linked to performance. The performance-pay element should be stretching and have regard to the long-term. Under supporting principle A.4, non-executive directors are identified as being responsible for executive remuneration. The board is required to be sensitive to pay elsewhere in the group in setting the remuneration of senior managers. Under Appendix A to the Code, remuneration incentives are required to be compatible with risk policies and systems.

Since publication of the Cadbury Report on Corporate Governance in 1992, there have been numerous efforts to curb what is

DIRECTORS' DILEMMA 14: EXECUTIVE REMUNERATION

seen by many in the UK as excessive executive pay. While 'soft' law regulations have been increasing since then, executive pay has also increased significantly.[51] Independent research shows that arm's length remuneration consultants may be part of the problem not the solution.[52] Consider this: How long would a remuneration consultant last in business if they got the reputation of being tough on executive pay? Is it not their tendency to be soft on executive pay that makes them attractive as consultants? Thus, boards can point to the advice of arm's length consultants to justify the excessive pay awarded and remuneration consultants that recommend excessive pay are likely to obtain more business.

Following this line of thinking, there has to be a question mark over the appropriateness of boards using remuneration consultants rather than making pay decisions themselves on behalf of the shareholders who appointed them to do just that.

Application of ethical principles

There is an ethical dimension to executive pay. How much is any one person worth? Average CEO pay in the US was reported as exceeding $10 million for the first time in 2013.[51] The argument in favour of performance pay is to align the interests of shareholders and executives. But research has shown either non-existent or weak links between executive pay and company performance.[54]

DIRECTORS' DILEMMA 15: PACKAGE FOR RETIRING SENIOR EXECUTIVE

The scenario

You are a non-executive director on the board of a public body. The economy is in dire straits, the country having been bailed out by the European Union. You are a member of the remuneration committee. A voluntary severance scheme is underway to encourage staff to leave the company prior to retirement age.

A member of the senior management team with 19 years' service has applied to participate in the voluntary severance scheme.

The managing director has tabled the following proposal by way of exit package for the senior executive: a lump sum of approximately three years' salary of £437,000, plus a top up payment of a half year's salary of £68,000 per annum for the six years to normal retirement age.

In addition, it is proposed that the senior executive would work post-retirement as a consultant to the company and would serve on the boards of a number of subsidiaries garnering director's fees for these positions.

The managing director's proposal points out that these arrangements will allow for a much-needed consolidation of management positions within the company, including annual payroll savings of £368,000.

Question:

As a member of the remuneration committee of the board, would you approve the managing director's proposal concerning the exit package of the senior manager?

DIRECTORS' DILEMMA 15: PACKAGE FOR RETIRING SENIOR EXECUTIVE

Analysis – issues to consider/debate

- How does the governance of public bodies differ from the governance of, say, publicly listed companies?
- How are board directors of public bodies selected? How should they be selected?
- If invited to become a board director of a public body, what would be the risks and rewards of holding such a position?
- What questions would you ask the managing director in relation to his proposals?
- What are the risks and rewards of the proposal?
- Are there any knock-on implications of this proposal for the company?
- What alternative would you suggest to the managing director's proposals?
- What policies, processes and procedures of the company would you consult in preparing yourself for the forthcoming remuneration committee meeting?
- What policies, processes and procedures external to the company would you consult in preparing yourself for the forthcoming remuneration committee meeting?
- What high level principles would you consider important for the company to follow in this matter?

DIRECTORS' DILEMMA 15: PACKAGE FOR RETIRING SENIOR EXECUTIVE

Formulating a course of action

This dilemma involves termination pay for a senior executive. In the private sector, such termination arrangements have attracted attention for the propensity of departing executives to receive pay-for-failure remuneration. In this dilemma, the company is a public body. Arising from the business-politics interface in which such companies operate, this transaction has arguably higher reputational risk than in a private company context. A second element in the dilemma is the post-retirement arrangements for the exiting senior executive.

Identification of key parties to the dilemma

There are three key parties to this dilemma:

- Remuneration committee/board of directors: Given the sensitivity of this transaction on account of the size of the termination package, the board through the remuneration committee might examine the senior executive's contract of appointment and the terms of the early retirement scheme to ensure that the senior executive is obtaining just what is due under the contract. The board needs to be satisfied that this proposal meets the front-page-of-the-newspaper test. If this proposal were disclosed publicly, how would it be judged in the court of public opinion? The board also needs to know how this particular package compares with the treatment of other employees. While the managing director's proposal will result in significant cost savings (which claim needs to be challenged by the non-executive directors), the board has to be satisfied that the proposal is also value for money. Public bodies have a value-for-money remit which does not feature in private or listed companies. Will the transaction meet the approval of the Auditor General/Audit Office? It is not clear why the managing director is advocating such a generous exit package for one member of staff, or why the managing director wishes this member of the executive team to continue to serve as a consultant and subsidiary board member. This looks like a very generous deal for the senior executive, worth £846,000 (£437,000 + £68,000 x 6 years), together with consultancy fees and subsidiary board director fees which have not been quantified. If the senior executive worked to retirement age, he would only receive £816,000 in salary (£68,000 x 2 = £136,000 per annum x 6 years), together with a lump sum on his normal retirement date. The exact amounts involved need to be more precisely specified to enable the board to fully and properly evaluate the early-retirement package. The board may need to make further enquiries about this arrangement.
- Managing director: It is not clear why the managing director is pushing for such a generous termination and post-termination package for this departing executive. The managing director puts himself at personal risk with his board in bringing a proposal to the board that could cause discomfort to board members and which could result in reputational risk for the company and its directors if subsequently there is a political back-lash.
- Senior executive: If the package were disclosed publicly, as is much more likely for a public body subject to freedom of information legislation, would there be reputational risk for the senior executive (not to mention the board of directors)?

Legal regulations to be considered and any pertinent associated case law

There are no legal regulations concerning executive pay, other than the requirement to disclose the remuneration of directors. Statutory provisions in respect of private companies on directors' remuneration/directors' benefits generally require disclosure of annual remuneration, gains from the exercise of share options, payments under long term incentive schemes, compensation for loss of office and pensions paid to directors and former directors, distinguishing between remuneration for services (i.e., salary, bonuses, etc for day-to-day management) and remuneration as directors (i.e., directors' fees). Disclosure requirements are less onerous for small companies compared with large/medium-sized companies.

Guidance from codes of best practice such as The UK Corporate Governance Code

The remuneration requirements of *The UK Corporate Governance Code* have been summarised in Dilemma 14. Code provision D.1.4 addresses termination pay, the subject of this dilemma, and states that termination pay should avoid rewarding poor performance.

While *The UK Corporate Governance Code* would not apply to public bodies, it represents best corporate governance practice. Many public bodies voluntarily benchmark themselves against the Code.

DIRECTORS' DILEMMA 15: PACKAGE FOR RETIRING SENIOR EXECUTIVE

Given that the company in this dilemma is a public body, there may be additional public sector pay guidelines which need to be observed. In addition, the board needs to be clear on whether the transaction needs approval at ministerial or government department level as well as by the board.

Application of ethical principles

As this is a public body, it is likely this matter will be made public and could become a political issue. The board needs to be sure it can defend the departing executive's package in the 'court of public opinion'.

DIRECTORS' DILEMMA 16: TRADE-OFFS BETWEEN CONFLICTING OBJECTIVES

The scenario

You are a non-executive director of a railway company charged with running trains and managing the railway track infrastructure. Passenger safety is a regular topic on the board agenda. Passengers have persistently complained about the high price of train fares, and this has also attracted adverse newspaper coverage.

The company's chief transport officer has tabled a significant and very material capital expenditure project for the forthcoming board agenda. The proposal is to install a very expensive cutting-edge, state-of-the-art signalling system. The railway company will have the best and safest system in the world if the project goes ahead. The effect of the plan will be to significantly increase journey cost.

Included in the board papers is a survey of passengers who, asked their views on a more expensive transport system and a safer signalling system, have overwhelmingly chosen the less expensive option. Passengers have indicated that if prices go up they will move to a cheaper supplier, which has experienced a number of accidents resulting in serious injuries of its passengers.

Question:

Would you approve more expensive but much safer equipment which would result in loss of business because of higher prices?

DIRECTORS’ DILEMMA 16: TRADE-OFFS BETWEEN CONFLICTING OBJECTIVES

Analysis – issues to consider/debate

- What are the commercial issues at play in this dilemma?
- What are the trade-offs at play in this dilemma?
- What are the risks and rewards of approving/not approving the capital expenditure proposal?
- As a non-executive director, what are your responsibilities and how would you prioritise these?
- Would you approve the capital expenditure proposal, and why/why not?

DIRECTORS' DILEMMA 16: TRADE-OFFS BETWEEN CONFLICTING OBJECTIVES

Formulating a course of action

This dilemma entails cost-benefit trade-offs which involve issues of company performance, governance, reputation and ethics. In a nutshell, the trade-offs involve profitability versus customer/passenger safety. Resolving the trade-offs is a matter of judgement for the board of directors. As the network railway infrastructure and train companies are separated in the UK, this dilemma would not arise in that jurisdiction.

Identification of key parties to the dilemma

There are two key parties to this dilemma:

- Board of directors: The board is presented with a decision trading off significantly increased costs and likely reduced profitability in favour of passenger safety which passengers have indicated in a survey they will not pay for. The board needs to exercise scepticism and challenge the results of the survey. The results of such a survey are likely to be influenced by how the survey questions have been framed. Were the questions asked in a different manner would the results have been the same? Were the railway company itself to experience a significant railway accident in the future, and it were to come to light the board had not approved an expenditure on passenger safety, judgement of the board's decision is likely to be adversely affected by subsequent events not existing at the time of the decision. If the board chooses to invest in the safer signalling system, it might make this a unique selling point of the company and promote the company's services as safer than the competition.
- Customers/passengers: In addition, passengers might answer the questions differently were there to be a significant railway accident in the future. What people say in a questionnaire survey cannot be relied upon, as passenger views may change, and would certainly change in the event of an accident.

Legal regulations to be considered and any pertinent associated case law

It is beyond the scope of this report to discuss the detailed laws and regulations on health and safety. Under Section 37 of the Health and Safety at Work etc. Act 1974, in the event a company is found to have committed an offence under the Act, with the consent, connivance or neglect of a director, manager or secretary those parties are guilty of an offence. Obtaining convictions against individuals under this legislation can be difficult. The Corporate Manslaughter and Corporate Homicide Act 2007 introduced the offence of Corporate Manslaughter but only companies not directors can be found liable under the legislation.

In the recent case of Lion Steel,[55] where an employee fell through a roof, the managing director, finance director and one other director were charged with health and safety offences and with gross negligence manslaughter. Following a hastily convened board meeting, the directors instructed the company to plead guilty to the charge of corporate manslaughter. The company was fined £480,000.

Guidance from codes of best practice such as The UK Corporate Governance Code

The UK Corporate Governance Code advocates a long-term perspective for board decisions, referencing the phrase 'long-term success' a number of times.

The FRC's (2011) *Guidelines on Board Effectiveness* warns against boards paying insufficient attention to risk in making decisions.

Application of ethical principles

This dilemma deals with the trade-off between monetary rewards versus human safety. Which is more important: profit or human life? It also involves consideration of short-term versus long-term interests. Monetary rewards are current and measurable. The risk of an accident is in the future and contingent. It could be argued that in the long term, safer railways may attract more passengers.

DIRECTORS’ DILEMMA 17: CHARITY FUNDING SOURCES

The scenario

You were recently appointed to the board of directors for a charity, a company limited by guarantee, set up to promote mental health awareness and prevent suicide. This is a fantastic charity, which uses the internet to engage with people via forums, group counselling and one-on-one counselling sessions.

Two brothers set up the charity a couple of years ago after their brother committed suicide.

The charity was recognised both by an alcoholic drinks company and a mobile phone charitable foundation. Funding from these entities has enabled one of the brothers to operate as a full-time managing director of the charity, developing an impressive strategy for the charity.

Last week, you were contacted by the managing director to say that the most popular national radio disk jockey had ‘gone off’ on air about the alcoholic drinks company donating to a mental health charity because of the clear link between alcohol abuse and mental health issues. In a three-minute segment (where he did not name check but clearly implicated the charity) he is directly quoted as saying that the association was ‘criminal’.

Question:

As a board member, should the charity accept funding from the alcoholic drinks company?

DIRECTORS' DILEMMA 17: CHARITY FUNDING SOURCES

Analysis – issues to consider/debate

- Is the disk jockey correct in his comments about the association between alcohol and mental health?
- What policies and procedures should the mental health charity have in place in relation to fundraising?
- What are the risks and rewards of the charity accepting funding from the drinks company?
- What are the risks and rewards of the charity not accepting funding from the drinks company?
- What are the risks and rewards to the drinks company in funding the mental health charity?

DIRECTORS' DILEMMA 17: CHARITY FUNDING SOURCES

Formulating a course of action

Similar to Dilemma 16, this dilemma involves trade-offs. In this instance, the trade-off is between the not-for-profit company's dependency on donors for company survival versus the knock-on consequences of the donor's business affecting the company as recipient of the donation. There is growing awareness of the use of corporate philanthropy as a political device.

Identification of key parties to the dilemma

There are two key parties to this dilemma:

- Board of directors: It would be helpful were the board and management to develop a policy on donations to guide the charity and to set down fundamental principles guiding decisions on funding sources.
- Supporters: In formulating a policy, the board of directors might consult supporters of the charity and use the feedback to develop the policy on donations.

Legal regulations to be considered and any pertinent associated case law

This dilemma is not a legal issue. Rather, it is an issue of judgement for the board.

Guidance from codes of best practice such as *The UK Corporate Governance Code*

There are few guidelines from codes of best practice on the judgement issues entailed in this dilemma.

Application of ethical principles

Some would argue that there are no ethical issues in this dilemma; that alcohol does not cause mental health issues or suicide. Others would be more purist. Can the charity afford to be purist? Given that the charity may have no other fundraising options, the maxim 'beggars can't be choosers' comes to mind here.

Other considerations

An alternative twist - an alternative dilemma - might be whether a not-for-profit should accept money from a donor who has earned the money through illegal activities or through activities of questionable ethical standards.

DIRECTORS' DILEMMA 18: GIFTS

The scenario

You are a non-executive director in an engineering company that prides itself on having impeccable ethical standards.

In December, you hear from a staff member in the organisation that around Christmas time employees receive gifts from clients. This is a norm in the industry.

The gifts range from boxes of chocolates/bottles of wine, to cases of wine and other drinks, to gift certificates and cash.

As the company operates in countries all over the world, such gifts are a feature of doing business in those parts of the world. Further, to refuse such gifts would cause extreme offence to clients, as a result of which the engineering company would lose business.

Question:

As a non-executive director, what is your view of employees receiving gifts at Christmas?

DIRECTORS' DILEMMA 18: GIFTS

Analysis – issues to consider/debate

- How should boards/board members handle hearsay?
- What high level principles would you apply in this dilemma?
- What policies, processes and procedures of the company would you consult in this matter?
- What policies, processes and procedures of the company would you expect to be in place in this matter?
- What are the arguments for and against the company's staff receiving gifts at Christmas?
- How should the gifts received this coming Christmas be handled?

DIRECTORS' DILEMMA 18: GIFTS

Formulating a course of action

The giving and receiving of gifts are common in business – more common in some countries than in others. While the monetary amounts involved may be quite small, it is important to treat gifts properly, given their influence on the culture and ethics in the business. There are legal and reputational risks to companies as a consequence of inappropriate treatment of gifts. Staff also need to be protected from allegations of inappropriate behaviour.

Identification of key parties to the dilemma

There are three key parties to this dilemma:

- Board of directors: A key role of the board is to set the tone at the top. Although the amounts involved may not be material, gifts and hospitality are particularly important for the board to handle properly in setting the tone at the top. Does the company have a policy on gifts, hospitality, favours, sponsorship and entertainment? The policy should cover gifts offered, given, provided or accepted by employees and their family members. The policy should cover cash and non-cash items. The board has to consider whether a blanket prohibition on gifts is appropriate or whether gifts up to a certain value are acceptable. The policy should ensure that no gift could be construed as a bribe or payoff, and that any gifts do not violate laws or regulations. Gifts might be pooled within the organisation such that no individual could be accused of being influenced by a gift. Alternatively, gifts could be auctioned at the Christmas Party for charity.
- Management: If there is a policy on gifts, favours and entertainment, management must ensure that the policy is robustly implemented. Implementation may involve a carrot-and-stick approach. In particular, for employees found to have breached the policy, sanctions may be appropriate. Management may also have to introduce training for employees to ensure that they understand the policy in practice.
- Employees: In an industry where gifts are the norm, and where offence may be taken if employees do not accept a gift, the employer has a duty to protect employees through implementing an appropriate policy and guidelines for employees. This may entail keeping a register of gifts received/offered/accepted.

Legal regulations to be considered and any pertinent associated case law

The Bribery Act 2010 applies to UK companies and includes their operations outside the UK. Lavish gifts and hospitality could be caught under this legislation. In 2012, ICAS and the Serious Fraud Office provided guidance on gifts and hospitality under the Act. While recognising that *bona fide* hospitality or promotional or other legitimate business expenditure is an established and important part of doing business, the guidance warns that bribes are sometimes disguised as legitimate business expenses.[56]

Guidance from codes of best practice such as The UK Corporate Governance Code

The introduction to *The UK Corporate Governance Code* observes that the board's actions are subject to laws, regulations and shareholders in general meetings. Thus, the board should ensure that the company's policies on gifts and hospitality meets legal requirements. A requirement of *The UK Corporate Governance Code* is for the board to set the values of the company. These values should be reflected in a company policy on gifts and hospitality. A strong policy on gifts and hospitality is also likely to protect the company's reputation.

Application of ethical principles

Part C of ICAS's *Code of Ethics* addresses the issue of inducements for professional accountants. Inducements include gifts, hospitality, preferential treatment, and inappropriate appeals to friendship or loyalty. Offers of inducements may create threats to compliance with the Codes' five fundamental principles. The existence and significance of any threats will depend on the nature, value and intent behind the offer. If a reasonable and informed third party, weighing all the specific facts and circumstances, would consider the inducement insignificant and not intended to encourage unethical behaviour, then a professional accountant in business may conclude that the offer is made in the normal course of business and may generally conclude that there is no significant threat to compliance with the fundamental principles. When the threats cannot be eliminated or reduced to an acceptable level through the application of safeguards, a professional accountant in business shall not accept the inducement. A professional accountant in business is advised under the Code to evaluate any threats created by such offers and determine whether to take one or more of the following actions:

- inform higher levels of management or those charged with governance;
- inform third parties of the offer – for example, ICAS or the employer of the individual who made the offer – which may involve seeking legal advice before taking such a step;
- advise immediate or close family members of relevant threats; and
- inform higher levels of management or those charged with governance of the employing organisation of immediate or close family members.

DIRECTORS' DILEMMA 19: FAMILY BUSINESS DISPUTE

The scenario

In the 1950s, half-brothers Paul and Kevin founded a large cinema group which has been extremely successful. Some years ago, on their retirement, the two founders invited you to join the board as a non-executive director.

Sons of the founders are now on the board of this private company, looking after the respective family interests.

Paul II (a 25% shareholder) is taking a court action claiming that his rights as a minority shareholder are being suppressed by Kevin II who is chairman of the board. The articles of association of the company provide that the longest serving director (Kevin II) is to be chairman, with no limitation on the term of office of that person. Paul II is claiming in his court action that this is unfair and that instead the chairmanship should be rotated.

Kevin II is contesting the action, and has indicated that he will wind up the company if agreement that he remains as chairman cannot be reached.

The company has plans for significant expansion. Cinema ticket sales have held up, even in the recession.

As the only outside non-family non-executive director on the board, you have been asked to intervene in this dispute.

Question:

As a non-family non-executive director in the family business, how would you mediate between the two feuding brothers?

DIRECTORS' DILEMMA 19: FAMILY BUSINESS DISPUTE

Analysis – issues to consider/debate

- Is the governance of family companies different from the governance of, say, publicly listed companies?
- If you were a founder of a family company, would you invite an outside non-executive director to join the board?
- If you were a founder of a family company inviting an outside non-executive director to join the board, what characteristics would you like to see in a suitable non-executive director?
- If you were invited by a founder shareholder/managing director of a family company to join the board as an outside non-executive director, would you?
- What are the risks and rewards for the company of a non-executive director joining the board of a private family company?
- What are the risks and rewards for the family of a non-executive director joining the board of a private family company?
- What are the risks and rewards for the non-executive director of joining the board of a private family company?
- What are the issues concerning rights of minority shareholders?
- What are the articles of association of the company and how important are they?
- What steps would you take in mediating between the two brothers to resolve this dispute?
- What risks does this dispute entail for you as a non-executive director of the company?

DIRECTORS' DILEMMA 19: FAMILY BUSINESS DISPUTE

Formulating a course of action

While family businesses have many strengths, one of their weaknesses is their exposure to disputes between family members. This dilemma highlights the difficulties in family businesses when emotion, conflict and dispute can interfere with the conduct of the business. It is not uncommon for non-executives to be invited to join the board of a family business. Non-executive directors are not required by regulation on such boards. They therefore join the board on a voluntary basis.

Identification of key parties to the dilemma

There are two key parties to this dilemma:

- Non-executive director: Non-executive directors can be particularly useful as objective mediators in running family businesses including resolving family disputes. However, the risk of being dragged into a family dispute might make a person think twice about taking on a non-executive directorship in a family business.
- Paul II/Kevin II: It could be argued that Paul II and Kevin II are breaching their duty to look after the best interests of the company/shareholders as a whole by allowing their personal dispute to interfere with the best interests of the business.

Legal regulations to be considered and any pertinent associated case law

Section 171 of the Companies Act 2006 requires directors to act within their powers. Companies not acting within their power are acting *ultra vires* (outside their powers) and any related transactions may be deemed by the courts to be void and unenforceable. As the articles of association require the longest-serving director to be chairman, not complying with the articles could be found by the court to be acting *ultra vires*.

Directors have a duty to look after the best interests of their company/shareholders as a whole. Allowing a family dispute, and the relatively trivial issue of who is to be chairman, to threaten the success of the company is arguably a breach of that duty.

Both statutory law and common law provide protection to minority shareholders. Under Section 994 of the Companies Act 2006, a minority shareholder can petition the courts on the grounds that they have been unfairly prejudiced. Whether the courts would find that not rotating the position of chairman amounts to oppression of a minority shareholder is debateable, especially where the articles of association provide otherwise.

Guidance from codes of best practice such as The UK Corporate Governance Code

While not explicitly requiring boards to have terms of reference (called board mandates by some codes), such a requirement is implicit in code provision A.1.1 when it states that the board should have a formal schedule of matters reserved to it for decision. Such a statement of reserved functions of the board is likely to be included in a board terms of reference/board mandate document. Board terms of reference set out board processes in much more detail than in the articles of association. While not preventing disputes, such documents can assist in a shared understanding of board processes which should reduce the likelihood of board disputes. All boards should have board terms of reference.

Application of ethical principles

It is unethical and unprofessional of Kevin II and Paul II to allow their personal animosity to spill over into company business.

DIRECTORS' DILEMMA 20: MANAGING DIRECTOR-CHAIRMAN DYNAMIC

The scenario

You are a non-executive chairman of the board of directors of a listed company. You are in the happy position that the managing director has been performing spectacularly well, receiving awards in recognition for his success and recently appearing on the front page of the leading business magazine.

The managing director runs a tight ship, commanding authority, and obtaining significant respect from his staff. You have been impressed at the manner in which senior executives demur to the managing director's authority at board meetings, at all times taking their lead from the managing director.

Having worked with the managing director for a number of years, you have grown to trust him, particularly as he has delivered consistently better results than his peers in the sector and has avoided any public controversy during his tenure. The managing director has been so successful on the acquisition trail that case studies of his achievements have been written in universities on his methods of integrating acquisitions into the business.

The board's policy is to continue on the acquisitions' trail.

The managing director has informed you that he plans to table a proposal at the board meeting next week and urgently needs board support to progress his proposal. The proposal involves the biggest acquisition in the company's history. The managing director tells you that negotiations have been underway for some time, but could not be discussed due to the risk of the proposed deal becoming public. The managing director has also given you assurances that a full and robust due diligence will be carried out by the external auditors once the board gives the go-ahead for the deal and before the deal is finalised. Projections show that following the deal the company will move from number four to pole position in the sector.

Question:

As chairman of the board, would you support the managing director's acquisition proposal?

DIRECTORS' DILEMMA 20: MANAGING DIRECTOR-CHAIRMAN DYNAMIC

Analysis – issues to consider/debate

- What is the role of a board chairman?
- How does the role of board chairman differ from that of managing director?
- Which is better in a listed company – that the role of chairman and managing director be combined or separated?
- How does the relationship between the chairman of a board and the managing director affect board dynamics?
- How should a chairman and a managing director divide communication issues between them?
- As chairman, would you be happy with the behaviour of the managing director in this dilemma?
- As chairman, would you have any concerns about the behaviour of the managing director in this dilemma?
- What are the risks and rewards of the acquisition proposal tabled for next week's board meeting?
- What processes should boards adopt in making big decisions to ensure as much as possible that the right decision is made?
- What questions would you ask at the forthcoming board meeting concerning the acquisition?
- What external advice, if any, should the board obtain in relation to this proposal?
- What is your view on the involvement of the external auditors in the acquisition?
- What are the essential components of an effective due diligence process?
- As a non-executive director, and mindful of the board's role to govern not manage, how much evidence would you ask to see of the due diligence process?
- What questions would you put to those who have conducted the due diligence process?
- Are the information flows between the board and management concerning the acquisition appropriate?
- You have heard that boards and individual directors suffer from 'groupthink' and other behavioural and social psychological biases. What are those biases?
- What steps could boards take to mitigate against behavioural and social psychological biases?
- In relation to this dilemma, do you see any evidence suggesting issues with behavioural and psychological biases?

DIRECTORS' DILEMMA 20: MANAGING DIRECTOR-CHAIRMAN DYNAMIC

Formulating a course of action

This dilemma involves a number of issues: relations between the chairman and managing director, the decision to approve the acquisition, and board processes to reach that decision. Corporate governance is about people. Inter-personal relations can strongly influence the execution of corporate governance. Arguably the key relationship is between the chairman and managing director. Related to the chairman-managing director relationship is the distribution of power between the two and between the board and management. Boards suffering from managerial hegemony (management capture) are *de jure* (in law) but not *de facto* (in practice) governors of the company. Motives of managing directors in undertaking large acquisitions are not always congruent with the best interests of the company/shareholders as a whole. Research has systematically found that usually target company shareholders gain in acquisitions but bidding companies loose out. Research has also shown that managing director/CEO motives for acquisition may have more to do with growing an empire than with generating shareholder value. Acquisitions involve putting large amounts of shareholders' money up front for the promise of returns at some future time. This is risky. Added to this is are research findings showing that managers are generally over-optimistic. This sub-conscious bias/tendency can be costly for companies and therefore needs to be constrained by a strong board. The urgency of the transaction is also of concern. Finally, the fact that negotiations have been underway 'for some time' without the chairman's and board's knowledge is a concern.

Identification of key parties to the dilemma

There are four key parties to this dilemma:

- Chairman: The chairman of the board might be concerned:
  - o that such a big transaction was being planned without his knowledge;
  - o at the urgency of the decision required of the board;
  - o at the lack of trust from the managing director justifying not communicating with the board in case the information became public; and
  - o at the capacity of the company to take on such a large acquisition.

- Board of directors: The board has to observe due process and undertake appropriate due diligence, which cannot be rushed. A thorough business case setting out the risks and rewards must be presented to the board by management. The board has to ensure that such a large acquisition is within the risk appetite of the company. The board also has to interrogate the projections concerning future profitability after the acquisition. What assumptions underlie the calculations? Are those assumptions realistic? Will they actually be realised? The board may also need to take soundings from shareholders as to whether they are likely to look favourably on the transaction. The board will need to consider whether there is a cultural fit/compatibility between the two organisations.
- Managing director: The managing director is making a big personal gamble. Assuming the acquisition is approved by the board, the acquisition not delivering as promised may put the managing director's own position at risk.
- External auditors: The managing director is proposing that the external auditors will carry out the due diligence. Are the external auditors the right/most independent group to carry out due diligence or are they conflicted? The advantage of using the external auditors is that they have worked with management of the bidding company for many years and are familiar with the bidding company management team and will therefore be able to complete the work in a tighter timeframe. But would it be safer for the board to hire independent consultants? The managing director, who clearly wishes to make the acquisition, may want to hire advisors to reaffirm his own wishes. Is appointing the external auditors to carry out this due diligence work compliant with the bidding company's policy on non-audit services? Are there any risks to external auditor independence arising from this assignment?

Legal regulations to be considered and any pertinent associated case law

An acquisition of the size in this dilemma (i.e. 'biggest in the company's history') may have competition law implications which will have to be investigated. A further legal consideration is whether the board is permitted under law and the company's articles of association to enter into such a large transaction without shareholder approval. Finally, provisions of T*he Takeover Code*[57] will need to be taken account of.

DIRECTORS' DILEMMA 20: MANAGING DIRECTOR-CHAIRMAN DYNAMIC

Guidance from codes of best practice such as The UK Corporate Governance Code

The Walker Review (2009: 45),[58] published following the 2008 banking crisis, discusses the skills needed for effective non-executive directors. Those capabilities are identified as being particularly relevant 'where a dominant and hitherto apparently successful chief executive seeks to embark on an aggressive growth or acquisition strategy'.

Some techniques for boards to ensure good decisions are made, including:

- breaking up decision-making processes;
- taking enough time to make the decision;
- changing the dynamic in the boardroom to enhance quality of decision making
- changing the atmosphere in the boardroom to allow/encourage critical discussion, so that consensus is not the norm;
- teaching the board/board members how to challenge;
- introducing processes that allow reflection;
- considering the possibility it might be the wrong decision;
- finding reasons not to agree with management's proposals;
- allocating different roles within boards;
- instructing board members not to agree;
- putting in place devil's advocate – contrarian directors to challenge decisions;
- recording the arguments – the pros and cons – in the minutes; and
- removing management more quickly after problems emerge.

Application of ethical principles

This dilemma is not so much one of ethics but one of relationships, power and board process.

DIRECTORS' DILEMMA 21: NON-COOPERATION WITH CONSULTANTS

The scenario

Her Majesty's Treasury has appointed external consultants to carry out a value-for-money report on a public body, as is normal periodically in the public service. The value-for-money report has to be completed within two weeks, before the next scheduled board meeting.

The managing director is newly appointed from the private sector and sees board members as the only parties entitled to any detailed information.

The managing director has instructed a senior manager not to release market documents to the value-for-money consultants to assist them in completing their report. The documents are extensive, related to a specialist sector and contain the only likely source of data to evaluate performance and market share.

The managing director does not interact with board members in the normal performance of his duties outside board meetings.

The company secretary has contacted you as chairman to inform you of this matter.

Question:

Would you support the managing director's instructions that no market documents should be released to the value-for-money consultants?

DIRECTORS’ DILEMMA 21: NON-COOPERATION WITH CONSULTANTS

Analysis – issues to consider/debate

- How does the governance of public bodies differ from the governance of, say, publicly listed companies?
- How are board directors of public bodies selected? How should they be selected?
- If invited to become a board director of a public body, what would be the risks and rewards of holding such a position?
- What principles are relevant in relation to sharing confidential company information with other parties?
- What regulations are relevant in relation to decisions about sharing confidential company information with other parties?
- What is your view on the managing director’s attitude to the request for information?
- What is the role of the company secretary in matters such as this?
- Was the company secretary correct to go behind the managing director’s back and contact the chairman?
- On receipt of the information from the company secretary, what should the chairman do?
- What are your views on the lack of direct contact by the managing director with the board between formal meetings?
- To what extent should the board engage with the company outside formal scheduled meetings?
- To what extent should the non-executive directors interact among themselves outside formal scheduled meetings?

DIRECTORS' DILEMMA 21: NON-COOPERATION WITH CONSULTANTS

Formulating a course of action

While this dilemma deals with a behavioural issue – the unwillingness of the managing director to co-operate with consultants – it also concerns information asymmetry in the form of the managing director withholding information, together with issues of confidentiality. The managing director not interacting with board members outside meetings is another issue of board dynamics in this dilemma.

Identification of key parties to the dilemma

There are four key parties to this dilemma:

- Board chairman: This is an issue the chairman has to raise directly one-on-one with the managing director. There will be no board meeting within the timeframe of resolving the issue. As it could involve sensitive personal interactions, the chairman might consult the non-executive directors to elicit their views on the matter and to obtain their advice on how she should deal with the matter in her conversation with the managing director. The chairman has to find out the concerns of the managing director contributing to his unwillingness to release the information. The chairman needs to check the job description of the managing director and what it says about his duties concerning disclosure of company information. The chairman might raise her and the board's expectations relating to board activity outside formal board meetings.
- Managing director: The managing director appears misguided in his attitude to company information and in his dealings with the board. This may be the first time the individual has held the role of managing director. If so, he might be advised to request a more experienced professional to mentor him in his new role. He might also obtain some training to help him understand his role in the governance of the company. Boards and governance do not just operate during board meetings. An effective board, led by an effective chairman, will be in constant contact outside board meetings, not least because this will contribute to good social chemistry in the group. As the board has the power to hire and fire the managing director, it is important that he communicates well with his board and individuals on the board. Not interacting with board members outside meetings is a risk for the managing director.
- Company secretary: The position of company secretary is critical in terms of ensuring good board processes and procedures, and even more importantly, in terms of good information flows between management and the board. The company secretary is a member of the management team and at the same time has particular duties to the board. This can present a company secretary with conflicts between her role as manager and as the board secretary, particularly in circumstances where information is being withheld from the board. One has to assume that the company secretary has first spoken to the CEO and only then has resorted to the chairman. The company secretary has to be commended for bringing the problem to the chairman, even though it may create difficulties for the company secretary with the managing director.
- Board of directors: Communications between the managing director and the board only take place at formal board meetings. In most boards, a considerable amount of activity takes place informally outside board meetings. Poor lines of communication may represent a risk for the company and lead to a dysfunctional board. The board may need to more formally establish communications protocols at and in between board meetings.

Legal regulations to be considered and any pertinent associated case law

It is likely (but not absolutely certain) Her Majesty's Treasury has the power to require the company to provide documentation to the value-for-money consultants.

Guidance from codes of best practice such as The UK Corporate Governance Code

Under supporting principle B.5, *The UK Corporate Governance Code* states that under the direction of the chairman, the company secretary's role is to ensure good information flows within the board and its committees, and between management and non-executive directors. Under code provision B.5.2, appointment and removal of the company secretary is identified as a matter for the board.

DIRECTORS' DILEMMA 21: NON-COOPERATION WITH CONSULTANTS

Application of ethical principles

Confidentiality is a fundamental principle of the ICAS *Code of Ethics*. A professional accountant should not disclose confidential information to third parties without proper and specific authority and unless there is a legal or professional right or duty to disclose. Under paragraph 140.0, the principle of confidentiality is not only to keep information confidential but also to take all reasonable steps to preserve confidentiality. In the circumstances of the dilemma, a professional accountant would have to determine whether there is a legal or professional right or duty to disclose information.

DIRECTORS' DILEMMA 22: BEHAVIOUR OF AUDIT COMMITTEE CHAIRMAN

The scenario

You are the chairman of the board of a publicly listed company. You rely heavily on the chairman of the audit committee who is recognised by everyone as doing an outstanding job for the company in very difficult financial circumstances.

The board is holding its 'away day' abroad at the premises of a subsidiary.

The board meeting is preceded the evening before by a nice dinner accompanied by fine wines.

During the night there is an incident involving the company secretary and the chairman of the audit committee. The company secretary claims that the audit committee chairman appeared three times outside her bedroom door in a state of complete undress. The company secretary made a complaint to the chairman.

While accepting that the incident occurred, the audit committee chairman claims no memory of the event, stating that it is well known he suffers from time to time from sleepwalking.

Question:

How would you as board chairman handle the audit committee chairman's behaviour?

DIRECTORS' DILEMMA 22: BEHAVIOUR OF AUDIT COMMITTEE CHAIRMAN

Analysis – issues to consider/debate

- Should boards have away days in foreign locations?
- Should boards have dinners with fine wines on their away days in foreign locations?
- What are the issues facing the board arising from this incident?
- Are there any legal implications arising from this matter?
- Are there any implications under company policy arising from this matter?
- Did the audit committee chairman engage in wrongdoing or inappropriate behaviour?
- What is the role of the company secretary in relation to the audit committee?
- Can the company secretary continue to exercise her role in relation to the audit committee after the incident on the away day?

DIRECTORS' DILEMMA 22: BEHAVIOUR OF AUDIT COMMITTEE CHAIRMAN

Formulating a course of action

Board away days are opportunities for board members to spend more time on company business and to see first-hand, on-the-ground company operations. They are also a valuable opportunity for directors, and directors and managers, to get to know each other better in more informal circumstances than permitted at board meetings. This builds trust which can facilitate better boardroom dynamics. As the board is responsible for the values of the company, it is essential that board members set the tone in their personal as well as professional behaviour.

Identification of key parties to the dilemma

There are three key parties to this dilemma:

- Chairman: This is a matter the chairman has to deal with on a one-on-one basis. An investigating is required to confirm the facts of the incident. During the investigation, consideration has to be given to whether the audit committee chairman needs to withdraw from board activity until the investigation is complete. The chairman may consult her board colleagues, particularly the non-executive directors, for their opinion and guidance on how to handle this awkward personal situation.
- Audit committee chairman: As three visits were made to the company secretary's bedroom, the claim of sleepwalking becomes harder to believe. If the claim of sleepwalking is not true, it would appear that the audit committee chairman has behaved highly unprofessionally and inappropriately. Directors are ambassadors for their companies. They therefore have a duty to behave in a manner that does not bring the company into disrepute.
- Company secretary: The company secretary has been put in a very difficult situation by the incident. It is hard to see how she can continue to execute her duties while the audit committee chairman remains in place, both on the audit committee and on the board.

Legal regulations to be considered and any pertinent associated case law

The company secretary is likely to have legal rights under employment law arising from the incident. The chairman of the audit committee also has rights concerning preservation of his good name and professional reputation.

Guidance from codes of best practice such as The UK Corporate Governance Code

Many best-practice codes require companies to put in place codes of conduct for employees. If the company has such a code of conduct, the audit committee chairman's behaviour might be judged against the Code, as might the company's response to the incident. The audit committee chairman should be treated in the same way that any other employee would be treated after such an incident.

Application of ethical principles

Professional behaviour is a fundamental principle under the ICAS *Code of Ethics* and requires chartered accountants to comply with relevant laws and regulations and avoid any action that discredits the profession. In a different context to that envisaged by ICAS's *Code of Ethics*, the behaviour of the audit committee chairman in this dilemma could bring the company and the accounting profession into disrepute.

DIRECTORS' DILEMMA 23: BEHAVIOUR OF MANAGING DIRECTOR AND FINANCE DIRECTOR

The scenario

You are the chairman of the board of a publicly listed company.

You discover that the managing director has been having an affair with the finance director for the past two years. Both are single.

Question:

What would you do as chairman?

How would you as chairman handle the managing director's and finance director's behaviour?

DIRECTORS' DILEMMA 23: BEHAVIOUR OF MANAGING DIRECTOR AND FINANCE DIRECTOR

Analysis – issues to consider/debate

- Does the chairman have a role in this situation?
- If the chairman has a role, what are his/her choices?
- What are the implications of this matter for the board of the company?
- What are the implications of this matter for the management of the company?
- What are the risks, if any, for the company in this matter?
- What steps can the company take to mitigate the risks (if any) for the company in this matter?
- What are the risks (if any) for the individuals in this matter?
- What steps can the individuals take to mitigate the risks (if any) for the company in this matter?
- Should the company have a code of conduct dealing with such issues?
- If the company should have a code of conduct dealing with such issues, what should be in the code of conduct?

DIRECTORS' DILEMMA 23: BEHAVIOUR OF MANAGING DIRECTOR AND FINANCE DIRECTOR

Formulating a course of action

Problems of close interpersonal relationships in the workplace such as in this dilemma are not uncommon. The dilemma is whether the interpersonal relationships between two senior executives are issues of governance and a matter for the board. In order to address the dilemma, one has to view the problem from the perspective of what is in the best interests of the company.

Identification of key parties to the dilemma

There are three key parties to this dilemma:

- Board chairman: It is disconcerting for a chairman to discover such a relationship between the two most senior executives in the company. This may raise a question in the chairman's mind concerning other information about the company that has not been shared. For governance to work well there should be trust. People who discover deception inevitably will lose trust in the people who have deceived them. In relation to the appropriateness of the relationship, some might argue that personal relationships are commonplace in the workplace and on boards, for example, boards of family businesses. Many company codes of conduct discourage romantic relationships at work but it would be impossible to prohibit them outright. If the managing director and/or the finance director are doing a good job, it would not be in the best interests of the company to lose their services. For this reason, it is important for the chairman to handle the 'issue' sensitively.
- Managing director/finance director: The managing director and finance director may argue that what they do in their own time is a personal matter for themselves. However, taking on such senior positions comes with responsibilities and restrictions. The close personal relationship may introduce conflict of interest issues, between the two individuals on the one hand, and their duty to the company on the other hand. Arguably, a responsibility of a finance director is to consider the financial implications of proposed actions or decisions, which may require the finance director to point out that certain actions/decisions would not be in the best interests of the company. A close personal relationship between managing director and finance director may undermine the control system at the highest level in the organisation. Research has found that the most likely person to commit a material fraud is the managing director through her ability to override the internal controls arising from her position of seniority.[59] There are also reputational risks for the company if the relationship became public, gossip amongst staff, in the press, or on social media sites, or if the relationship broke up acrimoniously.
- Other board members: Other board members might also feel uncomfortable with the situation.

Legal regulations to be considered and any pertinent associated case law

There is a risk that the personal relationship between the managing director and finance director will cloud the execution of their fiduciary duty and even impinge on the exercise of due care and skill. The managing director and finance director have a duty to look after the best interests of the company. There are reputational risks to the company if the affair became public. There are operational risks to the company in the event the relationship sours.

Guidance from codes of best practice such as The UK Corporate Governance Code

This very real problem in practice is not addressed in best practice guidelines. Many companies have codes of conduct for employees which deal with personal relationships at work. The standards in those codes should apply equitably from top to bottom throughout the organisation. Does the company in question have a code of conduct for employees? Does the code of conduct require internal personal relationships to be disclosed? If not, then it could be argued the managing director and finance director have not breached company policy by not disclosing their affair.

Application of ethical principles

The ICAS *Code of Ethics* does not specifically address personal issues. However, some of the higher level principles such as the requirement for professional accountants not to allow bias or undue influence of others to interfere with professional or business judgement are relevant.

DIRECTORS' DILEMMA 24: SHREDDING COMPANY DOCUMENTS

The scenario

You are the chairman of A Limited which has had a history of corporate governance problems.

You hear from another board member of a complaint about the managing director of A Limited.

The board member has been contacted by the managing director of B Limited. The managing director of B Limited says that an employee of A Limited has told her that the managing director of A Limited has been seen shredding documents in A Limited's offices at 7pm one evening the previous week.

The board member has repeated what she has heard to you as chairman.

Question:

How would you as chairman raise the shredding of company documents with the managing director?

DIRECTORS' DILEMMA 24: SHREDDING COMPANY DOCUMENTS

Analysis – issues to consider/debate

- How should boards/board members handle hearsay?
- As chairman, what would you do on receipt of information about the shredding of company documents?
- What steps would you as chairman take to protect yourself on receipt of the information about the shredding of company documents?
- What is the responsibility of the managing director of B Limited in this matter?
- Should the chairman raise this matter with the managing director?
- Should the chairman raise this matter with the internal auditors?
- Should the chairman raise this matter with the external auditors?
- What are the risks and rewards of shredding company documentation?
- Is the behaviour of the employee of A Limited appropriate?

DIRECTORS' DILEMMA 24: SHREDDING COMPANY DOCUMENTS

Formulating a course of action

Documents are the legal property of the company. No member of staff has a right to destroy valuable company property – whether physical assets or corporate documents. However, there is no evidence in the dilemma of wrongdoing. The documents being destroyed could be part of a housekeeping/tidy up by the managing director. Nonetheless, that the shredding is being done by the managing director rather than support staff, and at a late hour in the evening, creates a suspicion of wrongdoing.

Identification of key parties to the dilemma

There are five key parties to this dilemma:

- Employee of A Limited: This employee has arguably 'blown-the-whistle' on activities in A Limited. The communication was not in the form of a formal whistleblowing report. Nonetheless, a matter of possible wrongdoing has been communicated to someone outside A Limited. One wonders whether A Limited has an effective whistleblowing policy and, if so, why the employee did not use this channel to express concerns.
- Managing director of B Limited: This person has received the communication of the employee of A Limited, who could be characterised as a whistle blower. Quite correctly, he has passed on the information to an appropriate person, a non-executive director of A Limited. Arguably, the managing director of B Limited has no further role in this matter.
- Non-executive director of A Limited: This director also appears to have acted appropriately, passing on the communication to the chairman of the board.
- Chairman of A Limited: The issue would be extremely difficult to investigate. The evidence has been destroyed. The nature of the evidence destroyed is not known. It would be difficult to investigate discreetly without alerting some staff and possibly the managing director himself. The chairman has to decide whether to make verbal enquiries of the managing director about the matter, which could be damaging to the chairman-managing director dynamic. The chairman currently has no evidence whatsoever of any wrongdoing or inappropriate behaviour. Of concern to the chairman might be that information about the company is being passed/leaked to another company.
- Managing director of A Limited: If the managing director of A Limited has shredded important company documents, he may have broken the law.

Legal regulations to be considered and any pertinent associated case law

Section 388 of the Companies Act 2006 requires accounting records to be kept for three years by a private company and for six years by a public company. Under taxation legislation, companies are required to keep adequate business and accounting records for six years, and in some cases longer than six years. Other statutes are likely to require certain records to be maintained. Shredding company documents in anticipation of court proceedings is also illegal.[60]

Guidance from codes of best practice such as The UK Corporate Governance Code

Code provision C.3.5 of *The UK Corporate Governance Code* requires the audit committee to review arrangements whereby staff may, in confidence, raise concerns about possible improprieties. The audit committee is required to ensure that appropriate arrangements are in place for proportionate and independent investigation and appropriate follow-up action

Application of ethical principles

The specific issue of shredding company documents is not addressed in the ICAS *Code of Ethics*. Inappropriate shredding of company documents is an ethical issue of which the accounting profession is particularly sensitive following events in 2001/2002 relating to Enron and its auditors, Arthur Andersen. Some Arthur Andersen staff were found to have shredded audit papers. This revelation played a part in the audit firm's subsequent collapse. The US Supreme Court subsequently overturned a conviction by a lower federal court that Arthur Andersen had inappropriately destroyed documents relating to the Enron audit.

DIRECTORS' DILEMMA 25: REGULATORY FINE

The scenario

You are a non-executive director on the board of a financial services life assurance company. You are aware that the regulator has been investigating the company's compliance with local and European life assurance regulations. The managing director reported at a previous board meeting that 'some issues' had arisen during the regulator's investigation.

You have seen a front-page story in today's newspapers that the regulator has imposed a very large fine on the company, for the following breaches:

i. Executives of the company entered into an agreement four years ago to lend securities within the company's portfolio that supported unit-linked policies to borrowers through an investment agent.

ii. Those executives did not receive approval of the investment committee before entering into the agreement. The agreement was in breach of internal company policy.

iii. The board was not informed of the agreement.

An emergency board meeting has been called to consider these issues.

Question:

As a non-executive director, what would be your position on the discovery of the regulatory fine on the company?

DIRECTORS' DILEMMA 25: REGULATORY FINE

Analysis – issues to consider/debate

- What executives and other parties are implicated in this event?
- What actions should the board take in this matter?
- What advice should the board obtain in relation to the actions it should take in this matter?
- What are the implications of this event for information flows in the company?

DIRECTORS’ DILEMMA 25: REGULATORY FINE

Formulating a course of action

This dilemma builds on Dilemma 10. In Dilemma 10 it was not clear that wrongdoing had occurred and the challenge for the board was to investigate the matter. In this dilemma, it is clear wrongdoing had taken place. The problem relates to the board reading about this for the first time in the newspapers. While the managing director reported at the previous board meeting that some issues had arisen, his language did not alert the board to the significance of the problem, so significant that the story merited front-page coverage and a ‘very large’ fine from the regulator. The use of such weasel words (i.e., ambiguous words that do not wholly truthfully describe what they purport to describe) by the managing director will be a concern to the board.

Identification of key parties to the dilemma

There are two key parties to this dilemma:

- Non-executive directors: The non-executive directors should be extremely concerned that they were not aware of such a significant matter until they read it in the newspaper. Their concerns should be exacerbated by learning that the irregularities and breaches had been going on for four years. The wrongdoing must have been very serious to merit ‘a very large’ fine. The non-executive directors will inevitably suffer some reputational damage arising from these events occurring on their watch. The non-executive directors will need to get a copy of the Regulator’s report, together with responses and explanations from management. The non-executive directors may decide to commence their own investigation into breaches of company policies which may lead to contracts with executives being terminated. The investigation may need to be carried out by independent external investigators, experienced in forensic investigations. As the external auditor may be implicated in the regulator’s findings, they may not be suitable to conduct the investigation. The non-executive directors may need to immediately commission legal advice. The non-executive directors may need to consider putting certain executives on gardening leave, and preparing succession plans in that event.
- Managing director/management: The managing director and senior management are required to keep the board informed of significant events and issues relating to the company. If management do not brief the board properly, it makes it impossible for the board to govern. Management appears to have been engaging in serious wrongdoing for four years without the board’s knowledge. It is difficult to see how the board can continue with the services of the managing director following this event.

Legal regulations to be considered and any pertinent associated case law

The issue of the provision of information to boards of directors is not addressed in statute law. It features in case law, often in suppression of minority interests cases. In relation to the common law duty to exercise due care and skill, there is an onus on directors to obtain sufficient information to enable them to carry out their duties.

Guidance from codes of best practice such as The UK Corporate Governance Code

Main principle B.5 of *The UK Corporate Governance Code* requires the board to be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. Under supporting principle A.3 (and repeated in supporting principle B.5), the chairman is responsible for ensuring that board members receive accurate, timely and clear information. The Code goes on to specify that management has an obligation to provide such information. Directors are required to seek clarification or amplification where necessary. This dilemma illustrates how difficult it can be for chairmen to meet these requirements, when management withholds information from the board.

The Walker Review (2009: 142)[61] published after the 2008 banking crisis raised the bar even higher by requiring not only knowledge of speech but also of silence: ‘The chairman, EDs and NEDs need to be experts in the ability to observe, interpret and draw conclusions about what people are giving clues about, but not talking about: that is, interpreting what lies just below the surface.’ This sets very high, arguably too high, expectations for directors. No less than a PhD in Psychology could be required ‘to observe, interpret and draw conclusions about what people are giving clues about, but not talking about’!

DIRECTORS' DILEMMA 25: REGULATORY FINE

Application of ethical principles

As part of the principle of integrity, paragraph 110.2 of the ICAS *Code of Ethics* requires professional accountants not to be associated with the omission of information or with obscuring information such that it is misleading. Under paragraph 320, professional accountants in business are required to present information fairly and honestly so the information will be understood in its context. Professional accountants in business are advised not to be associated with 'communications' which omit or obscure information such that it is misleading, whether due to external pressure or motivated by personal gain.

DIRECTORS' DILEMMA 26: WITHHOLDING INFORMATION TO RESOLVE A CONFLICT OF INTEREST

The scenario

You are a non-executive on a board of directors of a publicly listed company. Due to its historical origins prior to listing, there are two worker directors on the board.

One of the worker directors has been extremely belligerent on the question of the managing director's remuneration. The worker director has disrupted meetings, and caused one recent meeting to go on for six hours. Confidential board information has recently appeared on the front page of the Financial Times.

There has been some discussion among the independent non-executive directors of the conflict of interest for worker directors between their day jobs working in the business and their governance role on the board.

One of your fellow non-executive directors has suggested two solutions to the impasse:

i. to delegate to a remuneration sub-committee the task of setting the managing director's remuneration; and

ii. to only share information on the managing director's pay with board members other than the two worker directors

Question:

As a non-executive director, do you agree with the two solutions for dealing with the belligerent worker director? If you do not agree, how do you think the board should deal with the belligerent worker director?

DIRECTORS' DILEMMA 26: WITHHOLDING INFORMATION TO RESOLVE A CONFLICT OF INTEREST

Analysis – issues to consider/debate

- What are the corporate governance code requirements concerning remuneration of executives?
- What high level principles need to be followed in setting the remuneration of the managing director?
- What are the corporate governance code requirements concerning the conduct of remuneration committees of boards of directors?
- What elements should comprise the terms of reference of a remuneration committee?
- Is it permissible for the board to delegate decision making to a sub-committee?
- Can the board empower the remuneration sub-committee to set the remuneration of the managing director without consulting the board?
- If your answer to the above question is 'yes', how does this arrangement fit the requirement for a board to be collectively responsible for all decisions of the board?
- What are your views on only sharing information on the managing director's pay with board members other than the two worker directors?
- Is it appropriate that the two worker directors (and any other executive directors on the board) would be privy to confidential information on the remuneration of their boss?
- How should the chairman handle a belligerent director?
- Are the board dynamics as described in this dilemma well-functioning?
- What should be done about the leak of information appearing in the Financial Times?

DIRECTORS' DILEMMA 26: WITHHOLDING INFORMATION TO RESOLVE A CONFLICT OF INTEREST

Formulating a course of action

This dilemma is likely to be quite common in practice. Many board members will have experience of boards with conflicted directors. This may lead to leakage of information to competitors or elsewhere, such as the newspapers in this dilemma. It is tempting to resolve these problems by withholding information from certain board members. Boards like this one sometimes have meetings before meetings, creating an 'inner board', 'outer board' dynamic.

Identification of key parties to the dilemma

There are three key parties to this dilemma:

- Chairman: There is clearly a problem of trust in this dilemma. Silencing challenge is a risk to an effective board. The chairman should take steps to re-build trust with the worker directors which should contribute to better board dynamics. Of the two solutions proposed by the non-executive director to the problem in this dilemma, delegating to a remuneration sub-committee of the board the responsibility of setting CEO pay is a good one as it is defensible under best practice guidelines. The alternative of withholding information from the two worker directors would be inappropriate, would involve personal risk for the chairman, might encourage others to believe that withholding information from a board is acceptable (if the chairman can withhold information then so can I). Further, systematic withholding of information may make matters worse, further destroying any remaining trust there is. There is a suggestion the chairman has lost control by permitting the recent meeting to be hijacked and go on for six hours. The chairman's meeting-management skills therefore have to be in question. A good chairman needs exceptional inter-personal skills to handle disruptive and contrarian directors. Finally, it is a challenge for a chairman to deal with leaks from a board. The leak may have come from a board member or the leak may have come from a member of staff with access to the particular board information. All a chairman can really do is to remind board members of their duty of confidentiality, drawing their attention to the provisions on confidentiality in the board terms of reference.
- Board of directors: The suggestion of some board members receiving information while others do not might create an inner and outer board. This could be bad for board dynamics and could make current dysfunctional behaviour worse. The leakage of confidential board information to a national newspaper is also a problem for the board.
- Worker directors: This dilemma illustrates the problem of worker directors on a board. Worker directors are systematically conflicted by virtue of their position as employees in the organisation versus their position as director. The problem is exacerbated if the worker director is elected. An elected worker director may feel she has to report back to those who elected her. This can be problematic from a confidentiality perspective. Worker directors may have personal agendas beyond their duty as directors to look after the best interests of the company. This appears to be the case in this dilemma. Robust discussion, debate and disagreement are the hallmarks of an effective board – one that is not suffering from 'groupthink'. Discussion, debate and disagreement is not the same as disruptive behaviour. It is unprofessional at the very least to be disruptive on a board and to cause meetings to go on for six hours.

Legal regulations to be considered and any pertinent associated case law

The law does not provide guidance on setting executive pay. Not sharing information with all board members could involve legal (not to mention reputational) risk for those withholding the information.

Guidance from codes of best practice such as The UK Corporate Governance Code

The UK Corporate Governance Code requires a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors to be in place. No director should be involved in deciding her own remuneration.

Under code provision D.2.1, the board should establish a remuneration committee of at least three independent non-executive directors. The company chairman may also be a member of, but not chair, the committee if she was considered independent on appointment as chairman. The remuneration committee should make available its terms of reference, explaining its role and the authority delegated to it by the board.

DIRECTORS' DILEMMA 26: WITHHOLDING INFORMATION TO RESOLVE A CONFLICT OF INTEREST

The remuneration committee has delegated responsibility for setting remuneration for all executive directors. This is unusual. Generally boards do not delegate responsibility to board sub-committees. Rather, sub-committees advise boards on specific issues but responsibility for the issue remains with the board. For example, the audit committee is not responsible for approving the financial statements. That responsibility rests with the board. The audit committee assists the board in executing that responsibility. Remuneration committees are delegated responsibility for executive remuneration because the managing director is a member of the board. Following the principle that no director should be involved in deciding his own remuneration, it is not possible for the board to set the remuneration because the managing director is a member of the board.

Application of ethical principles

Under the ICAS *Code of Ethics*, professional accountants should not omit or obscure information such that it is misleading. This is contrary to the principle of integrity. Thus, the option of the chairman withholding information from the two worker directors would conflict with these provisions.

Confidentiality is a fundamental principle under the ICAS *Code of Ethics*. Information acquired as a result of professional and business relationships must be respected and therefore, not disclosed to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.

DIRECTORS' DILEMMA 27: HANDLING PRICE-SENSITIVE INFORMATION

The scenario

You are chairman on the board of a publicly listed company.

At the most recent board meeting, actual results compared with budget are very poor. The board agrees that the market must be informed of the deterioration in results. Having discussed the need to issue a profit warning, and the wording of such a profit warning, the board leaves detailed drafting of the precise wording to management. The company secretary is the lead on this task.

A week after the board meeting, you hear that after the board meeting, management team including the company secretary, had travelled to Frankfurt for an investor road show which had been long planned. To have cancelled the road show would have caused significant damage to the company. No mention was made of the profit warning during the investor road show, on the grounds that the wording had not yet been finally agreed.

Investors purchased significant tranches of company shares at this event.

Management issued the profit warning two days after the road show. The shares immediately dropped one third in price.

Question:

As a non-executive chairman of a publicly listed company, what would you do on discovery that management has been withholding price-sensitive information from the market?

DIRECTORS' DILEMMA 27: HANDLING PRICE-SENSITIVE INFORMATION

Analysis – issues to consider/debate

- How should boards/board members handle hearsay?
- What are the stock exchange regulations in relation to price-sensitive information?
- What are the difficulties for companies in implementing the stock exchange regulations in relation to price-sensitive information?
- What would you do (as non-executive chairman) on hearing about this incident?
- What are the implications for the company arising from this incident?
- What are the implications for the board arising from this incident?
- What are the implications for management arising from this incident?
- Who in management is implicated?
- What are the risks for the company arising from this incident?
- Did the board handle the issue of the profit warning at the board meeting properly? If not, what should it have done?

DIRECTORS' DILEMMA 27: HANDLING PRICE-SENSITIVE INFORMATION

Formulating a course of action

Price-sensitive inside information such as a profit warning (a sudden negative earnings surprise) must be disclosed 'as soon as possible'. The exact timing of the release of the profit warning was not agreed by the board nor was the exact wording of the profit warning agreed by the board.

Identification of key parties to the dilemma

There are three key parties to this dilemma:

- Board of directors: The judgement of the board in delegating the wording and timing of the profit warning to management has to be questioned. Should a board sign off on the exact warning before the release of the news announcement? Is releasing the profit warning two days after the board meeting 'as soon as possible'?
- Management: Once the question of price-sensitive/inside information has been considered, it is imperative that every step be taken to ensure no opportunities for insider trading.
- Company secretary: It is impossible to understand how any executive, let alone the company secretary who should be well versed in the laws and regulations, could consider it appropriate to attend an investor roadshow knowing that a profit warning was imminent.

Legal regulations to be considered and any pertinent associated case law

The UK Listing Authority (which is part of the Financial Conduct Authority) *Disclosure Rules and Transparency Rules* require companies to disclose inside information 'as soon as possible'. Inside information is information that is not generally available and is likely to have a significant effect on the share price. The term 'as soon as possible' is not defined. However, the *Disclosure Rules and Transparency Rules* state that the closure of the London Stock Exchange Regulatory Information Service is not sufficient grounds for delaying disclosure of inside information, implying that a two-day delay such as in this dilemma is not 'as soon as possible'. The Financial Conduct Authority may suspend the shares if it considers an announcement not to have been made within the appropriate time period or if there is a leak of inside information.

Guidance from codes of best practice such as The UK Corporate Governance Code

Disclosure of price-sensitive information is more a matter of 'hard' law (such as the *Disclosure Rules and Transparency Rules* referred to above) than 'soft' law comply-or-explain codes of best practice such as the UK Corporate Governance Code.

Application of ethical principles

A professional accountant is required to act with integrity, one of the ICAS *Code of Ethics* fundamental principles. Integrity means to be straightforward and honest in all professional and business relationships. Under the principle of integrity, professional accountants should not be associated with any reports or communications in which information is omitted. Untimely disclosure of price-sensitive information would fall into this category.

DIRECTORS' DILEMMA 28: BREACH OF CONFIDENTIALITY BY A BOARD MEMBER

The scenario

You are the chairman of a private family company.

You have heard from a company employee who happened to be on the same train, that a board member travelling to the board meeting the night before by train met some friends on the train, retired to the restaurant carriage, consumed large amounts of alcohol and entered into a sing-song with his friends.

Before this event, the board member had been reading his board papers in preparation for the meeting the following day, and he then left his board papers at his seat during the sing-song.

Question:

As chairman, what action would you take on hearing this news of a breach of confidentiality by a board member?

DIRECTORS' DILEMMA 28: BREACH OF CONFIDENTIALITY BY A BOARD MEMBER

Analysis – issues to consider/debate

- Should the chairman take any action?
- If the chairman should take action, what should that action be?
- What policies and procedures should there be in relation to board papers?
- Where should the policies and procedures in relation to board papers be located?
- How should the issue of confidentiality be addressed as part of board members' induction and ongoing training?

DIRECTORS' DILEMMA 28: BREACH OF CONFIDENTIALITY BY A BOARD MEMBER

Formulating a course of action

Confidentiality is a fundamental principle of the workings of boards of directors. Discussions at board meetings are confidential to those attending. To protect company confidentiality, boards need to be absolutely clear on who speaks for the company. Companies have two spokesmen: the managing director (or a delegate of the managing director) on all operational matters and the chairman on all matters relating to the board (such as recruitment or dismissal of the managing director).

Identification of key parties to the dilemma

There are three key parties to this dilemma:

- Chairman: The information received by the chairman is hearsay. If the report is true and board papers were left unattended, we do not know whether they were interfered with. The chairman can choose to do nothing on hearing of the incident where board papers were left unattended, can raise the issue one-on-one with the individual board member or can use the event to remind all board members of the importance of confidentiality, maybe drawing their attention to the relevant clauses in the board terms of reference.
- Board of directors: The board should have terms of reference/a board mandate which should address confidentiality issues and which should provide board members with clear guidance on what confidentiality means in practice. The confidentiality clauses in the board terms of reference should be sufficiently detailed to offer protection to directors in the event of confidential information becoming public. For example, what guidance is there say on keeping board papers in the boot of the car and the car is subsequently stolen?
- Board member: When confronted, the board member should apologise profusely for the incident. There is no defence to leaving confidential board papers unattended in a public place.

Legal regulations to be considered and any pertinent associated case law

Under common law, and following their fiduciary duties, directors owe a duty of confidentiality to the company. While fiduciary duties have been codified in Section 172 to 176 of the Companies Act 2006, the duty of confidentiality has not. Owing the duty of confidentiality to the company means that a director should not, without the company's authority, disclose confidential information.[62] Even shareholders are not entitled to receive company information. For example, they do not have a right of access to board meeting minutes.[63]

Guidance from codes of best practice such as The UK Corporate Governance Code

The requirement for confidentiality by boards is fundamental to good governance, yet is rarely, if ever, mentioned in best practice guidelines. For example, *The UK Corporate Governance Code* makes no reference to confidentiality, nor is it referred to in the FRC's (2011) *Guide to Board Effectiveness*. In relation to institutional investors (but not boards), the FRC's (2012: 10) *Stewardship Code* comments: 'Confidentiality in specific situations may be crucial to achieving a positive outcome'.

Application of ethical principles

Confidentiality is a fundamental principle of the ICAS *Code of Ethics*. A professional accountant should not disclose confidential information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose. Under paragraph 140.0, the principle of confidentiality is not only to keep information confidential but also to take all reasonable steps to preserve confidentiality.

DIRECTORS' DILEMMA 29: DESCRIBING A 'GREY' NON-EXECUTIVE DIRECTOR AS INDEPENDENT

The scenario

You are the recently appointed chairman of the board of a publicly listed company.

One of the non-executive directors has been sitting on the board for 20 years, since his company (of which he is founder-managing director) bought a significant holding of shares in the publicly listed company. As such, he is a representative director, representing his company's interests on the board of the publicly listed company.

The non-executive director (founder-managing director) has been chairman of the audit committee since he joined the board. He is insisting that he is independent and should therefore be allowed to continue to chair the audit committee.

He tells you as chairman of the board that if the board refuses to classify him as independent (allowing him to continue as chairman of the audit committee), he will instruct his company through the board to sell his entire shareholding, which could cause a very damaging drop in the share price for the company.

Question:

How should the board handle disclosure of the independence of the non-executive director in the annual report?

DIRECTORS' DILEMMA 29: DESCRIBING A 'GREY' NON-EXECUTIVE DIRECTOR AS INDEPENDENT

Analysis - issues to consider/debate

- What are the risks and rewards to the company of having a large shareholder represented on the board?
- What are the risks and rewards to the large shareholder of being represented on the board?
- What regulations need to be carefully considered in this situation?
- Why does the stock exchange put so much emphasis on director independence of the boards of publicly listed companies?
- Is it appropriate that directors are not considered independent after nine years of service on the board?
- Is it appropriate that directors are not considered independent if they represent a large shareholder?
- What are the risks to the company of having a non-executive director who is not independent chair the audit committee?
- Is it appropriate that companies choose to explain rather than comply with the Stock Exchange's corporate governance code?
- Why would it be important for the non-executive director to want to remain as chairman of the audit committee?
- Is it appropriate for the non-executive director to threaten to instruct his company to sell the shares in the publicly listed company?
- Is it appropriate for the non-executive director to instruct his company's board to sell its shares in the publicly listed company?
- How should the chairman handle the non-executive director's threats?

DIRECTORS' DILEMMA 29: DESCRIBING A 'GREY' NON-EXECUTIVE DIRECTOR AS INDEPENDENT

Formulating a course of action

The term 'grey' non-executive director refers to someone who has a connection to the company that precludes the person being classified as an independent non-executive director. In this dilemma, the non-executive director is a large shareholder and has been on the board for 20 years, both of which arguably compromise his independence. Boards of directors can choose to comply with *The UK Corporate Governance Code* or to explain non-compliance. This flexibility acknowledges that 'one size' does not fit all companies. If companies depart from the Code provisions, they have to explain why they have not complied. This means that if boards explain non-compliance, a bespoke customised explanation must be drafted to explain the company-specific circumstances justifying why for this company provisions of the Code are not appropriate. In addition to the classification decision, the chairman/board also have to consider the threat of the sale of a large tranche of shares in the event the audit committee chairman's wishes are not met.

Identification of key parties to the dilemma

There are three key parties to this dilemma:

- Chairman: The decision to describe a grey director as independent in the annual report is a matter for the board as a whole. The chairman's role is to discuss the matter privately with board members, possibly one-on-one, to try and avoid the issue becoming contentious at a board meeting which could adversely affect board dynamics. If the board decide to 'go to bat' for the audit committee chairman and not to comply with the UK Code of Governance, the board has to draft and agree an explanation for non-compliance. A resolution of the issue might be for the chairman to try and persuade the audit committee chairman to relinquish his chairmanship.
- Audit committee chairman: The chairman of the audit committee must be classified by the board as an independent non-executive director. After the positions of chairman and managing director, chairman of the audit committee is arguably the most powerful board role. It is not clear from the dilemma why the audit committee chairman is so exercised in wanting to remain as chairman of the audit committee. Maybe he wants to closely oversee his investment, which would be facilitated by being on the audit committee. The audit committee chairman may be able to influence company results by influencing the choice of accounting policies, which as a large shareholder could be useful. Those on the audit committee are privy to a lot more detailed financial information than other board members. Being privy to a large amount of information by a large shareholder presents insider trading risks. Could the large shareholder sell the shares without being accused of insider trading? Maybe the audit committee chairman would be wiser not to have access to too much information – or maybe even not to be a member of the board.
- Board of directors: If the board chooses not to comply with the provisions of *The UK Corporate Governance Code*, it takes on a risk that something untoward subsequently comes to light that, with the benefit of hindsight, makes their decision not to comply with the Code appear to be a poor one. In addition, the board needs to assess the risks to the company of having a non-executive director who is not independent chair the audit committee. For example, in this dilemma, how would the audit committee chairman handle a large fraud coming to light at an audit committee meeting, with price-sensitive-information implications? How would he manage the conflicts of interest of also representing a large shareholder who could lose significant sums from the likely share price reaction to news of the fraud?

Legal regulations to be considered and any pertinent associated case law

The threat by the audit committee chairman of the sale of his company's shares if his wishes are not met is an abuse of his power position in the company. He also puts his interests ahead of those of the company/shareholders as a whole, in breach of the legal requirements.

In relation to insider trading laws, the board should regularly brief directors on their legal rights and responsibilities to trade in the shares of the company including the circumstances and time periods when they can/cannot (closed dealing periods) deal in shares.

There are regulations governing the sale of shares in a company by its directors. For example, under the UK Listing Rules, directors may not trade in shares during close periods, i.e., periods before results announcements.

DIRECTORS' DILEMMA 29: DESCRIBING A 'GREY' NON-EXECUTIVE DIRECTOR AS INDEPENDENT

There may be a shareholders' agreement, put in place at the time of the original investment, the provisions of which will need to be complied with.

It is possible that the threat to sell shares might constitute a bribe under the Bribery Act 2010. A bribe is where a person offers, promises or gives a financial or other advantage to another person and intends the advantage to induce a person to perform improperly a relevant function or activity or to reward a person for the improper performance of such a function or activity.

Guidance from codes of best practice such as The UK Corporate Governance Code

Code provision C.3.1 of *The UK Corporate Governance Code* requires (on a comply-or-explain basis) all members of the audit committee to be independent non-executive directors. There are seven independence criteria (code provision B.1.1). One of the independence criteria is representing a significant shareholder. Another is serving on the board for more than nine years. Thus, the audit committee chairman breaches two of the seven independence criteria, having served on the board for 20 years and representing his company which has a significant holding of shares in the publicly listed company.

On this basis, the individual should not be chairman of the audit committee. The objective of the Code (p. 6) is that no one individual should have unfettered powers of decision.

However, the independence of each non-executive director is a matter for the board. If the board chooses to classify a non-executive director as independent notwithstanding relationships or circumstances which may appear relevant to its determination, it must state its reasons in the annual report for determining the non-executive director to be independent.

If the board chooses not to comply with the Code, and to retain the non-executive director as chairman of the audit committee, it has to include an explanation for non-compliance in the annual report. The FRC (2012, p. 6)[64] has received feedback that explanations should be 'relevant, specific and sufficiently informative'. Thus, the explanation should be customised and bespoke, and reflect the unique circumstances of the company that justifies non-compliance with code provision C.3.1.

Application of ethical principles

Section 340 of the ICAS *Code of Ethics* deals with financial interests of professional accountants in business which may create threats to compliance with the fundamental principles of the *Code of Ethics*. It is clear from the wording of this section of the *Code of Ethics* that professional accountants employed in listed companies are in mind. However, the advice can easily be adapted to a professional accountant on a board with financial interests in the company. Self-interest threats may exist through the motive and opportunity to manipulate price-sensitive information for personal financial gain. Methods of mitigating the self-interest threat include disclosure of relevant interests, disclosure of plans to trade in the shares to those in charge of governance, consultation with those in charge of governance or relevant professional bodies. The section concludes with the statement that a professional accountant in business shall neither manipulate information nor use confidential information for personal gain.

DIRECTORS' DILEMMA 30: MANAGING DIRECTOR BECOMING CHAIRMAN

The scenario

You are the chairman of the board of a publicly listed company.

The company has been a star performer and is the 'golden boy' of the stock exchange. The drive and charisma of the founder-managing director is largely responsible for this success. As a result, the founder-managing director has received many accolades and awards from the business community, and is lauded in the business press.

The founder-managing director appointed you to the board as one of his long-standing business confidants. As a result, over the years, you have become very wealthy, the value of your shares in the company having increased significantly.

The founder-managing director has indicated to you as chairman of the board that he wishes to relinquish the position of managing director, to hand on the reins to a younger person.

It is well known that you have been considering stepping down as chairman, as you feel it is time you took it easy, played more golf, travelled a bit more and enjoyed your wealth.

The founder-managing director has told you that the company's largest institutional shareholders have expressed their concerns that the company's performance will be adversely affected without the founder-managing director's leadership and have indicated their wish for the founder-managing director to stay on as chairman.

Question:

Should you as chairman continue with your plans to step down as chairman and make way for the founder-managing director becoming chairman?

DIRECTORS' DILEMMA 30: MANAGING DIRECTOR BECOMING CHAIRMAN

Analysis – issues to consider/debate

- What processes and procedures should companies adopt in appointing a chairman to a board?
- What are the key skills and character traits you would expect in an effective chairman?
- What are the stock exchange regulations concerning appointment of a chairman of a company?
- What are the stock exchange regulations concerning the founder-managing director becoming chairman of the company?
- What are the risks and rewards for the company of the founder-managing director becoming chairman?
- Is it appropriate for institutional investors to express their views on the chairmanship of the company?
- Is the manner in which the current chairman was appointed to the board appropriate?
- Why would the founder-managing director wish to stay on as chairman of the company?
- What are the implications for the successor managing director of the founder-managing director staying on as chairman of the company?

DIRECTORS' DILEMMA 30: MANAGING DIRECTOR BECOMING CHAIRMAN

Formulating a course of action

This dilemma is similar to Dilemma 29 in that it involves not complying with *The UK Corporate Governance Code*. This dilemma concerns the former managing director becoming chairman of the board. *The UK Corporate Governance Code* requires the chairman of the board to be independent on appointment, effectively precluding the managing director becoming chairman. Unlike Dilemma 29, it is apparently institutional investors, not the managing director, requesting non-compliance with the Code. The dilemma for the board is the risks it takes on by departing from best practice and something untoward subsequently comes to light. It is also not clear why the former managing director has to become chairman of the board. Can the former managing director remain on the board as a 'grey' non-executive director (i.e., not independent by virtue of being the former managing director)?

Identification of key parties to the dilemma

There are three key parties to this dilemma:

- Chairman: The chairman, together with fellow board members, needs to put in place a proper arm's length succession process to replace herself. In addition, the chairman of the board should speak directly with institutional shareholders to ensure that she understands their thinking. If the institutional shareholders persist in demanding that the founder-managing director be chairman, the chairman should obtain these demands in writing. The demand from investment managers for the company to breach best practice may not be official policy from their employers on corporate governance standards in their investee companies.
- Board of directors: Given that the founder-managing director appointed his friend as Chairman, it is also possible that other board members were selected for their friendship with the founder-managing director.
- Founder-managing director: The founder-managing director has clearly been in position for a long time. The imperative for the founder-managing director to become chairman, rather than remain on the board as a director, is not clear.

Legal regulations to be considered and any pertinent associated case law

Legal regulations are only likely to come in to the picture in the event of issues going wrong with the company. This could involve wrongdoing coming to light or the company experiencing financial difficulties resulting in it being put into liquidation.

Appointing a chairman is a matter of board process. Statute law provides almost no guidance to boards on issues of board process.

In relation to common law duties, the founder-managing director becoming chairman may be viewed by the courts as a breach of fiduciary duty between the interests of the company and those of the founder-managing director. While *The Corporate Governance Code* has no legal backing or authority, courts will look to such 'soft' laws as representing modern day standards of best practice, against which boards and directors will be judged.

In relation to common law duties, the board acceding to the founder-managing director's request to become chairman may be viewed as a breach of the directors' duty to exercise due care and skill. However, it is unlikely that appointing the founder-managing director as chairman on its own will cause problems. In the event of wrongdoing subsequently coming to light, that concession, taken with other facts, may paint an adverse picture of the board and board dynamics.

Guidance from codes of best practice such as The UK Corporate Governance Code

Code provision A.3.1 of *The UK Corporate Governance Code* requires (on a comply-or-explain basis) the chairman of the board to meet the independence criteria of the Code on appointment. There are seven independence criteria (Code provision B.1.1). One of the independence criteria is not being an employee within the previous five years. On this basis, the managing director is precluded from becoming chairman of the board on his retirement as managing director. The objective of the Code (p. 6) is that no one individual should have unfettered powers of decision.

If the board chooses not to comply with the Code, and appoints the founder-managing director as chairman, it has to include an explanation for non-compliance in the annual report. Chris Hodge, then Head of Corporate Governance at the FRC, writing in the Grant Thornton (2011, p.2)[65] annual review of compliance with the Code admits: 'It is not enough to simply say non-compliance suits one's business model: stakeholders deserve to know exactly why this is the case and what arrangements ensure that, despite non-compliance, the business – and their interests – are protected'.

Thus, the explanation should be customised and bespoke, and reflect the unique circumstances of the company that justifies non-compliance with Code provision A.3.1.

A further challenge for the board is the consequences if something untoward comes to light which with hindsight might reflect badly on the board's decision not to comply with the Code.

Application of ethical principles

The issue in this dilemma is more one of board process than ethics.

However, the ethics of the founder-managing director requesting, possibly pressurising, the board into appointing him as chairman, in circumstances that requires fellow directors to be party to a breach of the Code may be questioned. Objectivity is a fundamental principle of the ICAS *Code of Ethics* requiring professional accountants not to allow bias, conflict of interest or undue influence of others to override professional or business judgements. The fundamental principle of integrity requires professional accountants to be straightforward and honest in all professional and business relationships. Finally, the fundamental principle of professional behaviour requires professional accountants to comply with relevant laws and regulations and avoid any action that discredits the profession.

DIRECTORS' DILEMMA 31: GROUP MANAGING DIRECTOR ON SUBSIDIARY BOARD

The scenario

You are chairman of the board of a subsidiary of a global multinational, having been appointed to the position by the group managing director, with some minimal input from the chairman of the group board.

The subsidiary is very successful, and you have confidence in the subsidiary's management team.

The group managing director is a member of the subsidiary board, attending some but not all board meetings. His performance as group managing director has been stellar, so much so that case studies of his achievements have been written in universities.

However, you notice that managers' behaviour changes when the group managing director is present. They are quieter, less willing to speak their minds, and seem somewhat fearful of the group managing director.

You are also aware of a number of management changes following his visits, with senior managers leaving the organisation, for reasons that you cannot quite understand.

Question:

How should you as chairman handle the effect of the group managing director's presence on other managers?

DIRECTORS' DILEMMA 31: GROUP MANAGING DIRECTOR ON SUBSIDIARY BOARD

Analysis – issues to consider/debate

- How does the governance of subsidiary companies differ from, say, publicly listed companies?
- Who devises strategy for a subsidiary company?
- To what extent is the local subsidiary board free to run the subsidiary, independent from the parent company shareholder?
- What particular considerations would a non-executive director of a subsidiary have?
- How are subsidiary board directors selected?
- Was the manner of selection of the chairman of the subsidiary board appropriate?
- If invited to become a director of a subsidiary board, what would be the risks and rewards of holding such a position?
- Is it appropriate for the group managing director to be a member of the board of the subsidiary?
- Why does management behaviour change in the presence of the group managing director?
- What are the implications for the board of the change in management behaviour?
- How should the chairman of the board handle this situation?
- Who should the chairman of the board talk to about this situation?
- How might the organisation being a global multinational influence the situation?

DIRECTORS' DILEMMA 31: GROUP MANAGING DIRECTOR ON SUBSIDIARY BOARD

Formulating a course of action

The issue in this dilemma is the change in behaviour of managers when the group managing director is present. Why are managers quieter, less willing to speak their minds and seem fearful in his presence? A further puzzle is senior people leaving without explanation. Is the group managing director a dominant personality, a bully?

The Walker Review (2009: 142)[66] cautions: 'The chairman, EDs and NEDs need to be experts in the ability to observe, interpret and draw conclusions about what people are giving clues about, but not talking about: that it, interpreting what lies just below the surface.'

Identification of key parties to the dilemma

There are four key parties to this dilemma:

- Subsidiary board chairman: The subsidiary board chairman was appointed by the group managing director which may influence the subsidiary board chairman's independence. There is a suggestion in the dilemma of the group managing director being a dominant personality. This is reflected in the change in behaviour of subsidiary managers in his presence and changes in personnel following the group managing director visits. The subsidiary board chairman needs to find out exactly why changes in personnel are happening. The company secretary may be a valuable source of on-the-ground information. This represents a risk to the subsidiary board that subsidiary board managers may be acting in the group managing director's interests and not in the interests of the subsidiary. In addition, the unwillingness of subsidiary managers to speak their minds is of concern. The subsidiary board chairman has the additional problem of dual responsibilities: (i) as a wholly-owned subsidiary, there is a duty to do as requested by your shareholder; (ii) as a subsidiary operating in the local jurisdiction, there are legal responsibilities arising from duties under local laws and regulations. The subsidiary board chairman may need to escalate her concerns to the group, through the group board chairman.
- Group board chairman: The circumstances described in the dilemma are difficult for the parent company board. On the one hand, the stellar performance of the managing director would make the board reluctant to make any changes. Given the stellar performance, any changes might have quite negative market consequences. At the same time, the board has to be sceptical and question how the stellar performance is being achieved. Does the board fully understand the business model and the level of risks been taken to achieve the stellar performance?
- Group managing director: The motivation of the group managing director joining the subsidiary board is not clear from the dilemma. Maybe the group managing director wants to make sure he knows what is going on below group level. Maybe the group managing director does not trust the subsidiary company managers. The behavioural issues hinted at in this dilemma raises questions as to whether the group managing director is suffering from hubris. There is evidence that certain personality types, on acquiring a position of power, are prone to hubristic behaviour.[67]
- Subsidiary company managers: Managers in the subsidiary may be experiencing difficult trade-offs. On the one hand, they need to support the group managing director and act on his instructions. He is their boss. As is common in global multinational companies, the group managing director has probably appointed the local subsidiary company managing director and negotiated his remuneration which in turn influences the remuneration of then rest of the local management team. Accountability is more ambiguous in subsidiary companies. Local subsidiary managers are *de jure* accountable to the subsidiary board and are *de facto* accountable to the group managing director who sets/influences their remuneration.

Legal regulations to be considered and any pertinent associated case law

The influence of a dominant person is not explicitly addressed by law but can spill over into court proceedings where a dominant person causes other persons not to do their legal duty. Some court cases following the banking crisis are exemplars of this.

Guidance from codes of best practice such as The UK Corporate Governance Code

The FRC (2011) *Guidance on Board Effectiveness* advices boards to be aware of factors that limit effective decision making. One factor identified is a dominant personality or group of directors on the board which can inhibit contribution from other directors. *The Walker Review* (2009: 35)[68] also picks up this theme, advocating highly effective executive teams not dominated by a single voice, where open challenge and debate occurs, and yet the executive team is cohesive and collectively strong. *The Walker Review* (2009: 42) comments on the greater risk to board decision making culminating in 'executive group think' from the undue influence of a dominant CEO (possibly flanked by a CFO). It should be a high priority of the chairman to ensure there is open debate and challenge from within the executive team and the whole board which should not be dominated by a single voice.

Application of ethical principles

A dominant personality attempting to influence the decision-making process is identified in paragraph 300.12 of the ICAS *Code of Ethics* as an intimidation threat.

DIRECTORS' DILEMMA 32: FAMILY BUSINESS SUCCESSION

The scenario

The company is owned by a father, mother, grandfather and grandmother. Daddy founded the company, partly financing the company himself, but also obtaining capital from Mammy, Granny and Granddad.

The company has been extremely successful, with a net asset value that represents significant wealth potentially for the extended family, including Daddy and Mammy's seven children and Granny and Granddad's 12 great-grandchildren.

Daddy is chairman and managing director. The board comprises Daddy, three of his sons and two independent non-executive directors.

At a recent board meeting, under 'any other business', Daddy announced he will step down as managing director to be replaced by his eldest son. The board duly approved this and the eldest son was appointed managing director.

The next day, Daddy gets a letter of complaint from a non-executive director.

Question:

What is the role of the non-executive director in succession in the family business?

DIRECTORS' DILEMMA 32: FAMILY BUSINESS SUCCESSION

Analysis – issues to consider/debate

- How does the governance of family companies differ from the governance of, say, publicly listed companies?
- If you were a founder of a family company, would you invite an outside non-executive director to join the board?
- If you were a founder of a family company, inviting an outside non-executive director to join the board, what characteristics would you like to see in a suitable non-executive director?
- If you were invited by a founder shareholder/managing director of a family company to join the board as an outside non-executive director, would you?
- What are the risks and rewards for the company of a non-executive director joining the board of a private family company?
- What are the risks and rewards for the family of a non-executive director joining the board of a private family company?
- What are the risks and rewards for the non-executive director of joining the board of a private family company?
- How should succession issues be handled in private family companies?
- What are the components of a successful succession plan in a private family business?
- In the context of its specific circumstances, how would you design a succession plan for this company?
- What is the role of the founder-managing director in relation to succession in a private family company?
- What is the role of the board in relation to succession in a private family company?
- In relation to family businesses, you have heard the phrase 'blood is thicker than water?' What are the implications of this phrase for how you operate as a non-executive director?
- What are the arguments in favour and against having professional managers rather than family members to run a family business?

DIRECTORS' DILEMMA 32: FAMILY BUSINESS SUCCESSION

Formulating a course of action

A major challenge in family businesses is succession, from the first-generation founder(s), to second generation siblings/cousins, to the third generation and so on. As the business moves from first to second and third generations, the board and family have to decide the extent to which the business will be managed by the family versus professional management. Once outside non-executive directors are involved, as in this dilemma, the succession decision is not just a family decision.

Identification of key parties to the dilemma

There are two key parties to this dilemma:

- Daddy (chairman and managing director): Common to founder-managing directors, Daddy is acting as if the business is his business to do as he pleases. It is inappropriate board process for a matter as significant at the new CEO to be brought up without warning under 'any other business', arguably wrong-footing other board members.
- Non-executive director: It is not clear from the dilemma what happened at the board meeting. There is a suggestion that the non-executive director went along with the decision at the board meeting, implying that she did not have a problem with the eldest son being selected for the managing director job. The non-executive director has a duty to the company/shareholders as a whole. In executing her duty, she will want to see proper board process. Bringing outside non-executive directors into a family business requires the business to be more formal in its proceedings, which is an advantage to the business. It is likely that the non-executive director will be concerned for a number of reasons: (i) that the item of such significance was brought up during the meeting with no advance warning and with no prior discussion and consultation: (ii) that Daddy appears to assume that he has the right to select his successor: (iii) that a proper arm's length process was not conducted in arriving at the selection of the new managing director. However, one could question the approach of the non-executive director in addressing her concerns. Exchanging formal letters can escalate a problem that might be better dealt with face-to-face. A good deal of board activity happens outside formal meetings. The non-executive director might first discuss the matter with her fellow non-executive director. If they are on the same wavelength, they might arrange to meet Daddy together. In requesting a meeting with Daddy they need to be clear on their objectives. Do they wish to reverse the decision? Is the eldest son not suitable for the position? Have they got the right person for the job? Or are they just concerned with the lack of due process in arriving at the decision? Does the board have formal written terms of reference? Do the board terms of reference set out the board's responsibility for selecting the managing director?

Legal regulations to be considered and any pertinent associated case law

The law makes no reference to appointment of managing directors. The articles of association of the company may have provisions concerning appointment of the managing director. For example, it is possible that a family company may adopt articles of association specifying that the managing director be a member of the family.

Guidance from codes of best practice such as The UK Corporate Governance Code

Under code provision A.4.3, where directors have concerns about the running of the company, they should ensure that their concerns are recorded in the minutes (presumably those concerns having been aired at the board meeting). If the non-executive director expressed concerns at the meeting, then she needs to make sure the subsequent minutes of the meeting properly record those concerns. If she did not express her concerns at the meeting, then questions have to be raised as to why she was unwilling to express her concerns at the meeting.

Application of ethical principles

This dilemma deals more with issues of board process than ethics. However, Daddy may be in breach of ICAS's *Code of Ethics* fundamental principle of objectivity allowing bias towards his eldest son to override his business judgement.

DIRECTORS' DILEMMA 33: RESPONSIBILITY FOR FRAUD

The scenario

You are a non-executive chairman, with considerable financial expertise, on the board of a private financial services company. The company is subject to regular inspections by the regulator. Further, the company is subject to annual audit by a Big-Four audit practice. The regulator and external auditors have staff in the company's offices for weeks each year.

You have signed (together with the managing director) a letter of representation to the external auditors, stating that 'to the best of your knowledge and belief' there are no frauds in the organisation.

Very suddenly and without warning, three days ago, the regulator shut down the business. It transpires that proprietary trading losses incurred five years ago had been deliberately recorded on the balance sheet (statement of financial position) as assets. Removing those fictitious assets from the balance sheet (statement of financial position) has wiped out the company's capital. The managing director has claimed no knowledge of the fraud and has blamed the finance director for hiding these losses.

Question:

As non-executive chairman, do you have an exposure in relation to the discovery of fraud in the company?

DIRECTORS’ DILEMMA 33: RESPONSIBILITY FOR FRAUD

Analysis – issues to consider/debate

- What is a letter of representation and what is its purpose?
- Who drafts the letter of representation?
- From whom does the letter of representation come and to whom it is addressed?
- Who signs the letter of representation?
- What steps would you take before signing a letter of representation?
- What personal risks are you as non-executive chairman exposed to as a result of the closure of the company?
- What risks are the external auditors exposed to as a result of the closure of the company?
- What risks is management exposed to as a result of the closure of the company?
- How would you compare your risks as non-executive chairman and those of your co-signatory, the managing director?
- What steps would you take as non-executive chairman following the closure of the company?

DIRECTORS' DILEMMA 33: RESPONSIBILITY FOR FRAUD

Formulating a course of action

As part of the external audit process, every board of directors is requested by the external auditors to provide them with a letter of representation following the annual audit of the company's financial statements. Letters of representation are letters from the board/the directors addressed to the external auditors. The letter is usually signed by the same parties who sign the financial statements on behalf of the board. Often these are the chairman and managing director. The letter makes representations to the external auditors concerning amounts in the financial statements. The representations often concern difficult-to-audit amounts, prone to subjective judgements. The wording of the letter is drafted by external auditors at the end of the audit. Then it is submitted to the board for approval and signature, and returned to the external auditors as audit evidence for their files. It may be that the external auditors are motivated for the board to approve as many representations as possible. On the one hand, this provides the external auditors with more audit evidence. On the other hand, the letter of representation may let the auditors 'off the hook' in the event things go wrong in the company. Boards of directors, therefore, have to carefully scrutinise letters of representation to make sure that the representations drafted by the auditors for the board to approve and sign are representations that the board is comfortable making. Further, boards of directors should not sign the letter of representation without proper processes to support them in making the representations in the letter. A standard clause in a letter of representation requires directors to confirm to the auditors that 'to the best of their knowledge and belief' there are no frauds in the organisation. How do the directors (particularly the non-executive directors) know there were no frauds? Would it look well in a court were a director to say she signed the letter without any supporting process?

Identification of key parties to the dilemma

There are five key parties to this dilemma:

- Board of directors: The board of directors is required to formally approve the letter of representation at a board meeting before it is returned to the external auditors. Boards, and their audit committees on behalf of the board, must make appropriate enquiries before signing the representations to the external auditors. The question for the board is: what steps did it take before signing the letter, and before making the representations? The board will wonder how the company's fraud prevention policies and systems for fraud prevention failed. Material fraud is most likely to be committed at a senior levels in organisations. Those in positions of seniority may be able to override the control systems.
- Non-executive chairman: As the non-executive chairman who signed the letter on behalf of the board/non-executive directors, she will particularly have to be able to explain the steps taken before making the representations and before signing the letter.
- Managing director: While very material fraud unknown to a managing director can come to light (e.g., Barings Bank following the concealment of trading losses by Nick Leeson in 1999), it would be quite unusual for the managing director not to know about a material fraud. At the very least, not knowing of fraud on this scale (large enough to close down the business) raises questions about the managing director's competence.
- Finance director: It is difficult to imagine a finance director recording fictitious assets on the balance sheet (statement of financial position) without the knowledge of the managing director. What would be the finance director's motive in doing this without the managing director's knowledge? Motives for fraud include desire to earn bonuses, company survival, meeting bank covenants, saving jobs. These motives are likely to be shared by both the managing director and the finance director.
- External auditors: how could the external auditors have signed off on a set of financial statements containing a fictitious asset of such magnitude? The external auditors may have to demonstrate the audit work conducted to support the inclusion of this asset and its valuation in the financial statements.

Legal regulations to be considered and any pertinent associated case law

Fraud will be prosecuted by the state, provided a book of evidence can be assembled that is likely to lead to a successful prosecution. The regulator may also take action against board members, including the non-executive chairman, for negligence, for not taking due care and skill in executing her duties.

DIRECTORS' DILEMMA 33: RESPONSIBILITY FOR FRAUD

Guidance from codes of best practice such as The UK Corporate Governance Code

The UK Corporate Governance Code does not explicitly address fraud. Issues of fraud are more a matter of 'hard' law than 'soft' law.

Application of ethical principles

The ICAS *Code of Ethics* does not explicitly address fraud encountered by professional accountants in business.

Some would say how companies deal with fraud is a matter of ethics. Fraud should be addressed robustly. Brushing fraud under the carpet, not prosecuting fraud, is arguably unethical, bad for society, and encourages fraudulent behaviour.

DIRECTORS' DILEMMA 34: MATERIAL FRAUDULENT WRONGDOING

The scenario

You are chairman of the audit committee of a large listed financial institution.

The head of internal audit has informed you of the results of the investigation of a very serious fraudulent wrongdoing which you were aware was underway. You reflect that this will inevitably lead to a number of senior executives losing their jobs, including possibly the managing director.

Given the seriousness of the matter, and the reputational damage this will cause when the fraudulent wrongdoing which you were aware was underway becomes public, you request to see the internal audit files on the matter – something you have never asked for before.

There is clear evidence from email correspondence that executive A instructed executive B to engage in the fraudulent wrongdoing. You wonder who (if anyone) instructed executive A to issue instructions to executive B.

In reviewing the internal audit file, you note the internal auditors interviewed executive A and executive B. At their initial meetings with internal audit, both executives were economical with the truth. You note that the internal auditors held a second meeting with executive B, but not with executive A.

Question:

As chairman of the audit committee, has internal audit handled its fraud investigation properly?

DIRECTORS' DILEMMA 34: MATERIAL FRAUDULENT WRONGDOING

Analysis – issues to consider/debate

- What should the chairman of the audit committee do next in relation to the results of the investigation of wrongdoing?
- What questions should the chairman of the audit committee ask of the head of internal audit?
- Why did internal audit not interview executive A for a second time?
- What implications does not interviewing executive A have for the internal audit function in the organisation?
- Who (if anyone) is most likely to have instructed executive A to request executive B to engage in the wrongdoing?
- What communications issues need to be addressed in relation to the wrongdoing?
- What are the implications of this event for the culture/tone at the top of the organisation?

DIRECTORS' DILEMMA 34: MATERIAL FRAUDULENT WRONGDOING

Formulating a course of action

This dilemma involves investigating a wrongdoing/fraud by company executives. It is critical that investigation of wrongdoing/ fraud be carried out in an objective and independent manner, and sufficiently robustly to stand up to subsequent litigation either in relation to employment law (e.g., unfair dismissals) or in relation to criminal law. There is a hint in this dilemma that internal audit did not meet these standards. Why was executive B, but not executive A, interviewed a second time? The lack of evidence explaining why executive A issued instructions to executive B is also puzzling. There is propensity in large organisations on occasion for a 'fall guy' to take the blame for wrongdoing. Where this happens it means that the problem has the symbolic appearance of having been addressed, while the fundamental problem remains unaddressed. This is problematic for a board of directors, as the risks giving rise to the wrongdoing will persist, unaddressed in a substantive manner.

Identification of key parties to the dilemma

There are five key parties to this dilemma:

- Chairman of the audit committee: The audit committee needs to find out who commissioned the internal audit investigation and its terms of reference in conducting this audit. In addition, the audit committee needs to find out why executive A gave the instructions to executive B. The key puzzle in this dilemma is why internal audit interviewed executive B for a second time, but did not interview executive A who had instructed executive B to engage in wrongdoing. There are also questions over who else in the organisation was potentially involved in the wrongdoing. This raises questions over the thoroughness of the internal audit investigation, and possibly over the independence of the internal audit function. This may cause the audit committee to consider bringing in independent external investigation resources. Obtaining expert investigation advice, including legal knowledge, can reduce the risks arising from mishandling an investigation. The audit committee also needs to understand why executive A and executive B were economical with the truth at their first meeting with the internal auditor. The code of conduct for employees and the internal audit charter would require all staff to co-operate with all internal audit investigations and to truthfully answer internal audit questions. As the wrongdoing is 'very serious', the chairman of the audit committee will have to inform the chairman of the board who should call a full board meeting to discuss the matter. The audit committee also needs to review adherence to the company's fraud response policy in conducting this investigation.
- Board of directors: Among the issues to be considered by the board is whether external parties need to be informed, such as the regulator, the Stock Exchange and the police. A communication plan will be needed. Whether to suspend executives during the investigation is another consideration. Given the seriousness of the issue, the board may need to put in place a separate legal investigation of the matters that have come to light.
- Head of internal audit: Internal audit has a direct reporting line to the audit committee, with a secondary reporting line to the managing director. The head of internal audit reports to the chairman of the audit committee. The purpose of these reporting lines is to protect the independence of the internal audit function. Any suggestion of a compromise in the independence of internal audit will be a concern to the board.
- Executive A: There is apparent evidence executive A has been involved in wrongdoing. Executive A will need to access immediate personal legal advice. If executive A has acted on the instructions of others, executive A will need to consider the tactics in terms of using that as a defence in any subsequent legal proceedings.
- Executive B: As for executive A

Legal regulations to be considered and any pertinent associated case law

There may be legal implications arising from the fraudulent wrongdoing. If there are suspicions of fraud, the company and its auditors may have to inform the relevant authorities of their suspicions.

The UK Listing Authority *Disclosure Rules and Transparency Rules*[69] apply to companies listed on the London Stock Exchange. Such companies are required to release without delay to the London Stock Exchange Regulatory Information Service all inside information that would be likely to have a significant effect on the share price.

DIRECTORS' DILEMMA 34: MATERIAL FRAUDULENT WRONGDOING

Guidance from codes of best practice such as The UK Corporate Governance Code

As mentioned in Dilemma 33, *The UK Corporate Governance Code* does not explicitly address fraud. Issues of fraud are more a matter of 'hard' law than 'soft' law.

Code provision C.3.2 of *The UK Corporate Governance Code* requires the audit committee to review and monitor the effectiveness of the internal audit function. Paragraphs 5.11 to 5.13 of *The Smith Report*[70] guidance provides additional guidance on how audit committees should oversee internal audit. In particular, it references the audit committee's role in appointing and terminating the head of internal audit, in ensuring internal audit has appropriate resources, in providing direct access for the head of internal audit to the audit committee chairman,

Application of ethical principles

The *ICAS Code of Ethics* does not explicitly address fraud encountered by professional accountants in business.

Fairness and equity to all parties concerned are the principles to be followed in investigating wrongdoing and fraud.

ENDNOTES

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A first class honours, first place in class, Science (Microbiology and Biochemistry) graduate of University College Dublin (UCD), Professor Niamh Brennan qualified as a chartered accountant with KPMG, holds a PhD from the University of Warwick and is a Chartered Director of the Institute of Directors (London). She is an Inaugural Honorary Fellow of the Institute of Directors in Ireland.

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ICAS recognises the power of every individual CA – 'The Power of One' – to influence those around them.

This report by Professor Niamh Brennan links closely with that theme through analysing 34 ethical dilemmas covering six areas commonly experienced by company directors. The dilemmas cover areas of particular challenge in boardrooms, including directors' fiduciary duties/conflict of interest, the exercise of due care and skill, decision making, behavioural issues, information asymmetry and the conduct of board business. The primary aim of the report is for the dilemmas to be used for discussion and debate, led by an expert on the workings of boards of directors, either in a classroom/training setting or in a business setting.

The ethical dilemmas encountered in business are often complex and stressful, and the dilemmas analysed in this report raise issues common to boards across the globe. Although reference is made to a UK regulatory context, including the UK Corporate Governance Code, many of the regulatory principles are applicable in other jurisdictions. The dilemmas could therefore easily be used outside the UK by tailoring the context and discussion accordingly, thus helping to embed ethical values and thinking into the day-to-day work of company directors wherever they may be based.

ISBN 978-1-909883-09-3
EAN 9781909883093

Price: £10

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