

104 Auditors and corporate governance

18 mins

The Cadbury report referred to audit as being a cornerstone of good corporate governance.

Explain:

- (a) Corporate governance and why good corporate governance is important
- (b) The role of auditors in contributing to good corporate governance

(5 marks)

(5 marks)

(Total = 10 marks)

105 Directors and corporate governance (Pilot Paper)

18 mins

- (a) Explain briefly what is meant by 'corporate governance'.
- (b) Within the context of corporate governance examine the role of, and relationship between, executive directors and non-executive directors.

(4 marks)

(6 marks)

(Total = 10 marks)

106 Stakeholders

18 mins

- (a) Outline the major types of stakeholder found in companies.
- (b) Discuss what is meant by 'the knowledge gap' and what measures have been taken in company law to bridge it.

(4 marks)

(6 marks)

(Total = 10 marks)

104 Auditors and corporate governance

Text reference. Chapters 14 and 22.

Top tips. This question needs you to explain the concept of corporate governance and also to explain why it is important that corporate governance is good. This is a very important element of part (a) of the question and you should ensure that you do not neglect it. In part (b) you need to look at the role of auditors. Do not just explain what they do, however. You need to link back their duties and task to the concept of corporate governance.

Easy marks. State what is meant by (a) corporate governance and (b) auditors (definition).

(a) Corporate governance and its importance

Corporate governance is the **system by which companies** (bodies corporate) **are directed and controlled** (governed).

It is important that companies are governed well because companies are often directed and controlled by different people from those who have an interest in the company. Such interested parties are known as **stakeholders**.

Examples of **stakeholders** in a company may include:

- Shareholders (members of the company)
- Employees
- Tax authorities
- Customers
- Society
- Creditors

Each of these parties has a **stake** in the company. For example, shareholders finance the company, employees depend on the company for their livelihood, tax authorities rely on the company's returns of their profitability to assess them for their tax liabilities, customers using their products and so on.

It is therefore important to each of these parties that the company is **well run** and is not defrauded or run into unnecessary financial difficulties. The **leadership** of the company (**directors**) are in a position by their policies to seek to prevent such problems. Bad corporate governance can open the company up to all sorts of problems.

(b) Auditors and corporate governance

An audit is an exercise undertaken by qualified, **independent professionals** to ensure that the **financial statements** prepared by the directors for the benefit of shareholders give a **true and fair view of the company's affairs** at the end of the accounting period. It consists of a number of tests and judgements, and is undertaken in accordance with national or international auditing standards.

The directors are required by law to produce **financial statements** for the shareholders, giving a **report** of how the company has performed **financially** and where it stands at the end of the reporting period. These have to be prepared according to national or international financial reporting standards.

Audit is therefore a **check** on whether the directors are complying properly with this aspect of corporate governance. It is **primarily for the benefit of shareholders**, for whom the financial statements are an indication of how their investment in the company is doing, and what return they may expect.

105 Directors and corporate governance

Text reference. Chapters 19 and 22.

Top tips. This question needs you to explain the concept of corporate governance. In part (b) you need to look at the different roles that the different directors have. Do not just explain what they do, however. You need to link back their duties and tasks to the concept of corporate governance.

Easy marks. State what is meant by (a) corporate governance and (b) auditors (definition).

Marking Scheme

Marks

- | | |
|------|---|
| 8-10 | A good explanation of the meaning of corporate governance generally and the roles of the two types of directors in particular. Reference might well be made to the OECD or the Combined Code. |
| 5-7 | A sound understanding of this area, although perhaps lacking in detail. |
| 2-4 | Some understanding of the area, but lacking in detail, perhaps failing to deal with the relationship of the two groups of directors. |
| 0-1 | Little or no knowledge of the area. |

(a) Corporate governance

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It is therefore **important** to each of these parties that the **company is well run** and is not defrauded or run into unnecessary financial difficulties. The leadership of the company (**directors**) is in a position by their policies to seek to prevent such problems. Bad corporate governance can open the company up to all sorts of problems.

(b) Executive directors

An **executive director** is a director who performs a **specific role** in a company under a **service contract** which involves a regular, possibly daily, involvement in management. A director may also be an employee (usually a member of management) of their company.

Directors who have additional **management duties** as employees may be distinguished by special titles such as '**finance director**'. Such titles (with the exception of 'managing director') do not affect their personal legal position.

106 Stakeholders

Text reference. Chapter 22.

Top tips. This is a straightforward question which you should have no problems with if you are well revised in this area.

Easy marks

- List stakeholders
- State what is meant by 'knowledge gap' in part (b) (definition)

(a) Stakeholders

There are various stakeholders in companies:

Shareholders

The key stakeholders are the **shareholders** (members) who invest in a company and ultimately own it. They are concerned with how their investment is managed and what return they will obtain on their investment.

Directors

Directors are the people who run the company. They depend on the company for livelihood in terms of salary, fees or other remuneration. They may also depend on the company for status, if it is a high-profile company.

Employees

Directors are often **employees** of the company. Employees are also stakeholders, and there are likely to be employees other than directors. Employees depend on the company for their livelihood.

Customers and society

Customers and society at large are both stakeholders in companies. They will be affected by the company's product and sometimes by their processes (for example, pollution or other impacts on society).

Creditors

Creditors are also stakeholders in companies. They supply the company with goods or services and depend on them to pay for those goods and services within the credit terms extended.

(b) The knowledge gap

'The knowledge gap' is a way of describing the **gap between the information** about the company **available to shareholders** (the owners) **and available to directors and employees** of the company (the managers). In some cases, the owners manage a company, and shareholders are directors. In larger companies, however, this is rare.

Shareholders tend to make an investment in companies they are otherwise **unconnected** with and these companies are therefore managed by others. This situation means that the owners of companies are not privy to all the day to day information available at a company and are not in a position to direct **company policy**.

The role of company law

Company law and practice have adopted various measures to attempt to bridge this gap.

Financial statements

Directors are required to produce **financial statements** on an annual basis which give a **true and fair view** of the state of affairs of a company and of its profit and loss for the year for the benefit of shareholders and these financial statements have to be audited and filed on public record.

Annual general meeting

Public companies are also required to hold an **annual general meeting** (AGM) every year. Although management make day to day company decisions, certain decisions, such as what the articles of association contain and who are going to be directors, are reserved to the shareholders in general meeting. It is also an occasion where shareholders can put their views to directors and have dialogue with them.

Corporate governance codes

Voluntary corporate governance codes, such as the **Combined Code** in the UK, are becoming increasingly common for companies listed on Stock Exchanges. These set out good practice for companies and directors.