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CS PART III SECTION 5

GOVERNANCE AND ETHICS

THURSDAY: 29 November 2018. **Time Allowed: 3 hours.**

Answer ALL questions. Marks allocated to each question are shown at the end of the question.

QUESTION ONE

MOONSHINE COMPANY LIMITED (MCL)

Incorporated in 2008, Moonshine Company Limited (MCL) produced tomato puree concentrate for sale to multinational and local companies in the food and beverages industry. It had two subsidiaries, plastic and paper packaging for the food industry.

Since listing its shares in the securities exchange at a price of Sh.17 per share in March 2009, MCL had issued a number of profit warnings and had been plagued by corporate governance and audit issues.

In March 2010, MCL became the first company (since August 2009) to close below its Initial Public Offer (IPO) price at Sh.9 per share. Analysts attributed MCL's low market share price to inherent problems with its business model – a single product business which was highly leveraged.

As of 30 June 2011, many lead companies at the securities exchange began to issue profit warnings. As MCL did not issue a profit warning, its reported net loss of Sh.9.4 million for the six months period ended 30 June 2011 shocked the market. In a statement to the securities exchange authority, MCL directors attributed the financial loss to increase in administrative expenses, selling and distribution expenses and finance costs.

The independent directors (IDs) were unaware of the financial loss until four days before the release of the financial results. In reaction, the IDs commissioned a special audit and investigation carried out by Lituma Accounting Firm to review the circumstances surrounding the financial loss.

The special audit uncovered numerous accounting and governance irregularities which included:

- Understatement of cost of sales and stock, asset overvaluation and prepaid freight charges classified as receivables.
- Loans to directors were classified as accounts receivables and unauthorised loans were advanced to management, although the Articles of Association expressly prohibited management and board awarding themselves loans.
- The company did not file returns.
- The company did not have a corporate secretary.
- Dividends had been paid out of a capital reserve.
- Board minutes authorising key policy decisions and changes were not maintained.
- MCL board operated without board committees.

The IDs called an urgent meeting to review the special audit findings. The meeting resolved, among other things, to suspend the Managing Director (MD) and the Chief Finance Officer (CFO) and to appoint the General Manager as the acting Managing Director. The Managing Directors of the subsidiaries were also suspended. However, within the same month, the MD and the CFO were reinstated by the executive directors. The IDs did not cast their votes in the decision to reinstate the officers as they had realised that their votes could not influence the decisions made as the executive directors held the majority of the group shares.

To make matters worse, the group company reported that it might suffer an estimated loss of Sh.10 million in the second half of the year due to the shortage of raw materials and unfavourable weather conditions. The external auditors, XYN CPA, also raised a red flag on whether MCL was a going concern. The profit warnings continued into the first half of year 2012 with a reported net loss of Sh.15 million.

In 2013, the MD implemented a major restructuring strategy across the firm in the hope of turning operations around. The two loss making subsidiaries were sold.

The MD's efforts in rebuilding the company initially appeared to be effective and the company returned to marginal profitability in 2013 and 2014. Good news came in July 2015 when a foreign based company Starshine Company Limited (SCL) decided to invest its manufacturing assets valued at Sh.17 million in MCL thereby acquiring a 24% stake in MCL.

However, the joint venture with SCL did not turn around the situation. More profit warnings came in 2016 and 2017. MCL's financial statements raised a serious red flag with net current liabilities reported at Sh.54 million and negative operating cash flows of Sh.12.74 million. This prompted the newly appointed auditors KLM CPA to warn investors of potential going concern risks. Amid the mounting cash flow problems, the CFO resigned on July 2017. With a net loss of Sh.36 million in 2018, mounting debts and lawsuits, the situation got out of control. MCL was placed under statutory management and the shares were officially suspended from trading at the securities exchange.

Required:

(a) Analyse five challenges that were faced by independent directors of Moonshine Company Ltd. (MCL). (10 marks)

(b) Justify five actions that MCL shareholders or the board could have taken after the special audit findings, to salvage the company from imminent failure. (10 marks)

(c) Discuss three areas where the board and management of MCL failed in terms of compliance with the rule of law, governance and ethics. (6 marks)

(d) Advise the board of MCL on five responsibilities that they failed to discharge in relation to:

(i) Financial reporting. (5 marks)

(ii) Internal controls. (5 marks)

(e) Propose four terms of reference that could have guided the board of MCL in appointing the various committees of the board that were inexistent. (4 marks)

(Total: 40 marks)

QUESTION TWO

(a) Analyse five roles of the board in relation to stakeholder engagement. (5 marks)

(b) Propose four guiding principles for an effective board succession planning. (4 marks)

(c) Summarise six differences between "agency theory" and "stewardship theory". (6 marks)

(Total: 15 marks)

QUESTION THREE

(a) Explain the components of the "Triple Bottom Line" accounting framework in corporate sustainability. (3 marks)

(b) Suggest three ethical dilemmas that might be faced in corporate social responsibility (CSR). (3 marks)

(c) The concept of sustainability and social investment brings together the following types of governance:

- Economic governance.
- Corporate governance.
- Environmental governance.

Required:

Highlight three roles of each of the above types of governance. (9 marks)

(Total: 15 marks)

QUESTION FOUR

(a) In a corporate governance seminar, one of the facilitators noted that, "it is not always possible to foresee every situation that could give rise to real, or potential conflict of interest. However, there are certain ways that the board member or an employee is expected to react in instances where conflict of interest arises".

With reference to the above statement, suggest seven actions that the board member or an employee should take in instances where conflict of interest arises. (7 marks)

(b) Information technology (IT) risk management is a critical component of corporate governance. The chief information officer (CIO) is required to identify key areas of risk in order to discuss, strategise and budget for, with the support of management and the board of the organisation.

In relation to the above statement, propose four key areas of risk that the CIO needs to discuss, strategise and budget for. (8 marks)

(Total: 15 marks)

QUESTION FIVE

(a) (i) In the context of corporate governance models, explain "carver board model". (2 marks)

(ii) Organisations in the non-profit sector are increasingly adopting the advisory board model of governance.

Outline five roles of an advisory board. (5 marks)

(b) Discuss the following current trends in corporate governance:

(i) Social media governance. (2 marks)

(ii) Women on corporate boards. (2 marks)

(iii) Shareholder social activism. (2 marks)

(iv) Corporate compliance risks. (2 marks)

(Total: 15 marks)

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