

# KASNEB

## CS PART III SECTION 5

### GOVERNANCE AND ETHICS

THURSDAY: 24 November 2016.

Time Allowed: 3 hours.

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

#### QUESTION ONE

##### ELIXIR BANK LTD. (EBL)

Elixir Bank Limited (EBL) is a middle tier bank operating in the East African region and internationally. EBL provides financial services in four main areas; retail banking, corporate banking, small and medium-sized enterprises (SMEs) banking and insurance.

The bank adopts a service differentiation strategy and uses its research and development capabilities to introduce innovative banking services leveraging on technology.

The board of directors consisted of seven directors, with three independent directors (IDs); John Smith, James Roy and Jill Wallen. John Smith was appointed as the lead independent director. He sat on the boards of five other listed companies and also held other key positions, such as being a director of the National Trade Union Congress (NTUC). James Roy sat on the boards of other listed companies and was a senior executive in a healthcare group of companies, holding senior positions such as Executive Director (ED) and Chief Executive Officer (CEO) in hospitals and companies in the group. Jill Wallen had no prior experience as a director. All the three IDs were members of the remuneration committee, nominating committee and audit committee of the bank.

The four executive directors held key management positions in EBL as follows: Ted Rich was the Executive Chairman and CEO. Tim Kelly the Chief Operating Officer (COO), Tom Molly the Chief Technology Officer (CTO) and Theof Steve, Chief Financial Officer (CFO).

The board had diverse competences in business management, finance, accountancy, economics and healthcare. The board held meetings four times in a year, while the committees of the board held several meetings.

The troubles at the bank started when Ted Rich, the CEO and Chairman of the bank, pledged his entire stake of 56.29 per cent in the bank as collateral for a personal loan from Scotch Bank, an international bank. A loan default of shillings 3 billion by London Holdings (LH) an investment firm wholly owned by Ted Rich triggered the unravelling of the ownership of EBL. LH was a controlling shareholder of EBL, a fact that was unknown to many.

When Ted Rich defaulted on the loan in March 2016, Scotch Bank seized his shares in EBL and sold off the entire stake in the open market, causing Ted Rich to lose control of the bank. The forced sale of his shares triggered a premature redemption of convertible bonds worth shillings 1.2 billion, as the bond agreement included a covenant which required Ted Rich to remain in control of the bank.

The severity of the issue emerged when PVC, the bank's auditors issued an audit disclaimer on EBL financial statements due to going concern issues. TPL, a corporate advisory firm was then appointed as EBL's independent financial advisor to assess the implications of the default, as well as to recommend measures to be implemented in order to guarantee the going concern of EBL.

When EBL failed to produce its first quarter financial results in April 2016, PVC was engaged to review significant cash transactions between the months of January and March 2016 which were connected with Ted Rich's loan default. The CFO's resignation at the end of April 2016 on "personal reasons" raised eyebrows among the board members. No action was taken by the management to appoint a new CFO.

The other executive directors, the CEO, CTO and COO caused a shock in the market when on 5 May 2016 they tendered their resignation without giving any reasons. The independent directors pleaded with the executive directors to remain on board to ensure continuity. On May 29, 2016 they rejoined EBL. However it emerged that, when they were away, the key management had retained control of overseas branches and had access to the overseas branches bank accounts.

The audit report revealed that, at least shillings 1 billion worth of cash transactions were made without any prior approval or authorisation from the board. The audit report also exposed other dubious transactions which included siphoning money from the bank.

The individuals responsible for the dubious transactions made it difficult for PVC when the firm went to conduct audits in the branches overseas. Accounting branch officers were advised not to cooperate with the auditors and therefore forced them to leave the bank premises. They were unwilling to verify statements from the auditors and it appeared that two sets of books of account were maintained. PVC could not continue with the audit as a result of frustration.

The key management traded accusations and counter accusations in public where IDs accused EDs of misusing their power as directors. The EDs responded by claiming that the financial controller appointed by the board had misused the bank's funds through paying of professional fees to PVC and TPL instead of repaying the corporate bond.

To protect the interests of depositors and other creditors, the financial regulator placed the bank under statutory management and closed all its branches.

**Required:**

- (a) Analyse the composition of the board of Elixir Bank Ltd. (EBL), citing four ways in which it complies with the best practices in good governance. (8 marks)
  - (b) Discuss three potential conflicts of interest existing within EBL. (6 marks)
  - (c) Examine eight roles that the lead independent director was expected to discharge in EBL. (8 marks)
  - (d) Propose five governance measures that EBL could adopt in order to overcome the challenges it was facing. (10 marks)
  - (e) (i) Summarise to the board of EBL four mandatory matters that the audit committee is required to review. (4 marks)
  - (ii) Advise EBL audit committee on four powers they could exercise in order to improve the bank's operations. (4 marks)
- (Total: 40 marks)**

**QUESTION TWO**

- (a) Examine four likely challenges encountered in protecting confidential business information from potential security risks. (8 marks)
  - (b) Arcute Company Ltd. was established in mid 2016, and has recently constituted a board comprising new and inexperienced members.  
  
Assuming that you have been hired to train and induct the members, propose seven topics that you would include in your training manual. (7 marks)
- (Total: 15 marks)**

**QUESTION THREE**

- (a) One of the best practices in corporate governance is conducting a formal and rigorous evaluation of the performance of board of directors.  
  
Citing three reasons, highlight the significance of board evaluation. (3 marks)
  - (b) Evaluate four roles of ethical theories in regulating behaviour of members of an organisation. (4 marks)
  - (c) Examine four ways through which corporate organisations may implement corporate social responsibility (CSR) initiatives to address environmental issues. (8 marks)
- (Total: 15 marks)**

**QUESTION FOUR**

- (a) Outline five objectives of investor education programmes. (5 marks)
  - (b) In an enterprise risk management seminar, one of the facilitators noted that "Enterprise risk management consists of interrelated components that are derived from the way management runs an enterprise and are integrated with the management process".  
  
With reference to the above statement, discuss five components of enterprise risk management. (10 marks)
- (Total: 15 marks)**

**QUESTION FIVE**

(a) In the context of legitimacy theory, explain the following types of organisational legitimacy:

(i) Normative. (1 mark)

(ii) Pragmatic. (1 mark)

(iii) Cognitive. (1 mark)

(b) Many countries today have put in place institutional and regulatory frameworks to promote good governance in organisations. Despite this fact, many firms continue to be faced with financial frauds and scandals.

With reference to the above statement, suggest four adverse consequences of poor corporate governance. (4 marks)

(c) The board of XYZ Ltd. has approached you as the company secretary for advice on the various internal governance controls that the board should put in place.

Advise the board of XYZ Ltd. on four internal governance controls. (8 marks)

**(Total: 15 marks)**

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