SBL Progress Test 1 Solution (2022/2023)

Task 1 (taken from examiner answer)

In DCS's case there seem to be significant shortcomings in regard to the governance structures against broad principles of good governance.

These specific shortcomings are as follows:

Non-separation of the role of chairman and CEO
This is a serious weakness and leads to lack of independence within the board by vesting too much power in one individual who may be able to dominate the board of DCS. The two roles are very different in nature. The CEO is responsible for directing and implementing strategic plans and for leading the executive team. The chairman is responsible for ensuring that the board of directors operates effectively, that it is properly constituted and is managed impartially to encourage open and transparent discussion. These roles should be separated.

Lack of independent non-executive directors and diversity
DCS only has one independent NED to scrutinise the executive directors and to exercise independence of judgement and scepticism where appropriate. DCS's independent NED is an executive director of one of DCS's two main suppliers which is inappropriate. The company should appoint NEDs who are 'independent' and increase the diversity of the board, both in terms of functional expertise and business acumen and to benefit from the broader experience of those who have worked for other companies. The gender balance on the board needs addressing. Only the HR director is female.

No director or senior management induction policy
There seems to be no director induction process at DCS which is important in ensuring that directors and senior managers understand the mission, strategic objectives and cultural values of the organisation. Introducing such a programme will help integrate new senior staff into DCS and help them make more immediate and valuable contributions.

Lack of risk, nominations and remuneration committees
DCS seems to have no formal board appointed committees for the above. A public limited company is expected to have a committee which identifies, assesses and recommends strategies to mitigate risk. There is also no independent committee to consider board appointments or their pay structure. A particular problem related to appointments and rewards is evident from the case. At the senior level, this could have been avoided by having a formal nominations and remunerations committee to consider such appointments. A key shortcoming is the failure to adequately align director pay with the longer-term interests of the shareholders. No-one on the board is allowed share options and all are on a fixed salary meaning that company performance is not aligned to their rewards. A nominations committee would also have addressed some of the problems regarding poor selection and appointment of senior candidates, and the lack of succession planning.

Poorly constituted audit committee
The audit committee seems to be unsatisfactory for a number of reasons. First there seems to be no-one with any real financial expertise and this may be why costs are getting out of control. Most of the members are technical managers from the operating core of the business. There is only one independent NED when generally accepted principles of corporate governance would recommend at least two, if not more. The audit committee does not seem to have proper oversight over the capital budgeting of the company or scrutinise significant expenditure on capital expenditure or R&D. DCS should therefore change the constitution of the audit committee to include more NEDs and members

with more financial expertise. It should also review the remit of the audit committee to include induction and responsibility for oversight of the capital budgeting process, and to scrutinise the effectiveness of the financial reporting process, and its relationship with external auditors.

Inadequate reporting and engagement with institutional shareholders
There is a block of 30% institutional investors who seem to be largely ignored or treated as if they were like any other private individual shareholder. This is a key weakness as the institutional block vote is significant and if the shareholding is withdrawn or sold, this could create uncertainty in the market and a serious reduction in the share price. DCS needs to create formal reporting and communication channels with its institutional investors to ensure that they continue to engage with and invest in DCS.

Task 2

Shareholders
Before flotation High power, high interest because its owned mainly by the founder and any return made belongs to them.

After flotation Has less power as there are now more shareholders, high interest given that institutional investors hold 30% interest.

Shareholders will be less actively involved in the management but institutional investors still important thus need to provide information to these group.

Employees
Before flotation There is no union for employees, and the employees are mainly loyal to the family members thus their power is low. Interest of employee is high as they directly benefit from DCS success.

After flotation An increase in employee skills and the establishment of union has increase the power of the employee. Interest remain the same and unaffected.

They were not involved in the strategy/direction merely following instruction, but after flotation, additional legislation, minimum wage, pension will result in more engagement with employee.

Lenders
Before flotation DCS has an insignificant borrowings thus minimal effort before they go for flotation.

After flotation Lenders has greater power through debt covenants, and their interest on company's ability to repay increases.

DCS will need to keep the lenders satisfied that they will be able to service the loan and also keep them informed about the gearing level.