CHAPTER 16

ENVIRONMENTAL, SOC...NS IN INVESTMENT ANALYSIS

1. (C) **supervisory board and a management board.**

Explanation

A two-tier board of directors consists of a supervisory board that oversees a management board. A one-tier board consists of a single board of directors, composed of executive and non-executive directors (meaning, respectively, internal and external directors).

(Module 16.2, LOS 16.b)

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2. (B) **also serves as chairperson of the board.**

Explanation

CEO duality exists when the chief executive officer also serves as chairperson of the board. CEO duality raises concerns that (relative to independent chairperson and CEO roles) the monitoring and oversight role of the board may be compromised.

(Module 16.1, LOS 16.a)

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3. (B) **Increase the asymmetry of information between the owners of the firm and the employees.**

Explanation

Decreasing the asymmetry of information between the owners of the firm (principals) and executives (agents) would help to control the principal-agent relationship (PAR) problem. The PAR problem arises from the agents (executives / employees) having more information about the company than the principals (owners / shareholders) and misusing that information to the advantage of the agents at the expense of the firm or principals. The other two answer choices are methods for reducing the PAR problem by affecting the behavior of agents by setting goals and principles of behavior and removing agents who misbehave and violate ethics.

(Module 16.1, LOS 16.a)

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4. (B) **dispersed ownership and dispersed voting power.**

Explanation

The combination of dispersed ownership and dispersed voting power is generally associated with shareholders who lack the power to exercise control over managers. In this scenario, there is a significant risk that managers will seek to use a company's resources to pursue their own interests; this conflict is known as a principal-agent problem. The combination of concentrated ownership and concentrated voting power, as well as the combination of dispersed ownership and concentrated voting power, are more closely associated with the principal-principal problem.

(Module 16.1, LOS 16.a)

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5. (C) **A senior manager also serves as a director on the board of another company.**

Explanation

A senior manager may serve on the board of another company so long as there are no other circumstances that may compromise objectivity. For example, problems arise if the boards of two companies are "interlinked" by way of managers of Company A serving on the board of Company B, and managers of Company B serving on the board of Company A.

(Module 16.1, LOS 16.a)

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6. (A) **two members of a board of directors are having an illicit relationship.**

Explanation

The PAR problem is generally viewed as being between shareholders (principals) and company executives (agents) but any employee of the firm could be viewed as an agent and therefore contribute to the principal-agent problem if they act in their own best interests to the detriment of the firm. Examples of the PAR problem are:

- CEOs enjoying on-the-job consumption in the form of excessive corner offices or lavish travel that is passed off as a necessary business expense.
- CEOs manipulating the board of directors for excessive compensation packages which are not linked to company performance.
- Executives seeking status by expanding the business (empire building) through acquisitions that do not benefit the existing shareholders. Company size has been strongly linked to executive compensation.

(Module 16.1, LOS 16.a)

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7. (C) **security risk exposures.**

Explanation

Environmental, social, and governance ("ESG") risk exposures are the nontraditional business factors that are now recognized as critical to a company's long-term sustainability.

(Module 16.1, LOS 16.a)

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8. (C) a lawyer recommends protracted legal proceedings to her client.

Explanation

Lawyers (the agent) are incentivized to recommend protracted legal proceedings to their clients (the principal) because this will generate income for the lawyer. The principal-agent relationship (PAR) arises when one group delegates decision making or control to another group. The PAR can create problems because the group receiving the power (the agent) generally has an asymmetric information advantage over the group making the delegation (the principal). The PAR problem begins if the agent uses the information advantage for their own best interests to the detriment of the interests of the principal. It is compounded as the asymmetric information makes it difficult for the principal to know enough to detect the problem and evaluate the agent's actions. Modern corporations are built on shareholders (principals) who delegate authority to run the business to executive officers of the company (agents). The board of directors are charged with overseeing the executives of the firm. It is possible for the board of directors to align themselves too closely with the executives of the firm thus contributing to the PAR problem.

(Module 16.1, LOS 16.a)

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9. (B) corporate governance.

Explanation

Corporate governance considerations, for example the structure of the board of directors, have a tendency to be relatively consistent across companies. In contrast, social considerations and environmental considerations often differ greatly.

(Module 16.2, LOS 16.c)

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10. (B) horizontal ownership.

Explanation

Horizontal ownership describes a scenario where companies with mutual business interests have cross-holding share agreements with each other. Pyramid (also known as vertical) ownership is the situation where a company has a controlling interest in two or more holding companies; and these holding companies have controlling interests in several operating companies.

(Module 16.1, LOS 16.a)

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11. (B) **shareholders and directors.**

Explanation

An agency relationship exists when an individual (the principal) acts on behalf of another individual (the principal). Such a relationship creates the potential for a principal-agent problem where the agent may act for his own well being rather than that of a principal. The key test of whether a principal-agent problem may exist is if one party is responsible for acting in the best interest of the other. Of the answer choices given, directors are responsible for acting in the best interests of shareholders.

(Module 16.1, LOS 16.a)

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12. (C) **Corporate governance considerations, such as the structure of the board of directors, tend to be inconsistent across most companies.**

Explanation

Corporate governance concerns, such as the structure of the board of directors, are likely to be relatively similar across most companies. By contrast, ESG considerations often differ significantly among firms. A key challenge of incorporating ESG factors into an investment analysis is finding and obtaining information that is pertinent and useful. Not only is ESG data and metrics inconsistently reported by companies, but such disclosure is not mandatory, which provides analysts further difficulties.

(Module 16.2, LOS 16.c)

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13. (B) **fixed-income analysis to identify upside opportunities.**

Explanation

In fixed-income analysis, ESG integration is generally focused on identifying downside risk. In equity analysis, ESG integration is used to both identify downside risks and potential opportunities.

(Module 16.2, LOS 16.d)

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14. (B) the agent may act for his own well-being rather than that of the principal.

Explanation

In a principal-agent relationship, one party (the agent) acts on behalf of another party (the principal). A principal-agent problem arises when the agent places his own interests ahead of the principal.

(Module 16.1, LOS 16.a)

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15. (C) chairperson.

Explanation

CEO duality is present when the chief executive officer also serves as chairperson of the board. CEO duality raises concerns that the oversight and monitoring role of the board may be compromised, relative to having chairperson and CEO roles independent. If the chairperson is not independent, (i.e., if these roles are combined), a company is likely to appoint a lead independent director in order to safeguard investor interests.

(Module 16.2, LOS 16.b)

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