# Learning Module 3: Corporate Governance: Conflicts, Mechanisms, Risks, and Benefits

Q.157 Corporate governance is a system that provides a framework that defines the rights, roles, and responsibilities of various groups. Which of the following groups *most likely* benefits from shareholder theory?

A. Directors.

B. Employees.

C. Shareholders.

The correct answer is **C.**

Shareholder theory posits that the primary responsibility of a company's management is to maximize the returns to its shareholders. This theory is grounded in the belief that shareholders, as the owners of the company, should be the primary beneficiaries of the company's success.

The theory argues that by focusing on shareholder value, a company will make decisions that are in the best interest of the company and, by extension, all of its stakeholders. This includes making investments that drive growth, improving operational efficiencies, and engaging in activities that enhance the company's profitability and market value.

**A is incorrect.** While directors may benefit indirectly from the implementation of shareholder theory through mechanisms such as stock options and bonuses tied to stock performance, the theory itself primarily benefits shareholders directly. Directors are tasked with governance and oversight roles that include making decisions in the best interest of the shareholders. However, the primary aim of shareholder theory is not to benefit the directors but to ensure that the company is managed in a way that maximizes shareholder wealth.

**B is incorrect.** Employees, like directors, may benefit indirectly from the successful implementation of shareholder theory through job security, bonuses, and other performance-related incentives. However, shareholder theory explicitly prioritizes the interests of shareholders over other stakeholders, including employees. However, the primary objective of shareholder theory is not to maximize employee benefits but to increase the value returned to shareholders. Stakeholder theory, in contrast, advocates for a more balanced approach that considers the interests of all stakeholders, including employees, in the decision-making process.

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Q.158 Which of the following statements are *least accurate* regarding good corporate governance?

A. A board should have the authority to hire third-party consultants.

B. Elections should be staggered to let the board members execute long-term plans.

C. A board should have a committee of independent members who set executive compensation.

The correct answer is **B.**

Staggering the election of board members, while it may provide stability and allow for the execution of long-term plans, is considered a less accurate representation of good corporate governance. This practice can serve as an anti-takeover measure, making it more difficult for shareholders to effect change in the board's composition in response to dissatisfaction with the board's performance or direction.

Staggering dilutes the value of shareholder voting rights since shareholders cannot replace the entire board at any given election. This can lead to a lack of accountability and responsiveness among board members, as they may feel secure in their positions for longer periods, potentially at the expense of shareholder interests and corporate performance.

**A is incorrect.** The ability of a board to hire third-party consultants is a hallmark of good corporate governance. This authority allows the board to seek external advice and services, such as legal, financial, or strategic consulting, which can be crucial for informed decision-making and oversight. Third-party consultants can provide independent perspectives and specialized expertise that the board or management may lack, contributing to more effective governance and risk management.

**C is incorrect.** The establishment of a committee of independent members to set executive compensation is another key aspect of good corporate governance. Such a committee, often referred to as a remuneration or compensation committee, is tasked with developing and proposing remuneration policies for directors and key executives. This includes setting performance criteria, evaluating performance, and determining appropriate compensation levels. The independence of the committee members is crucial to ensure that executive compensation is fair, transparent, and aligned with the long-term interests of the company and its shareholders.

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Q.159 Which of the following board of directors committees is *most likely* responsible for identifying candidates for senior roles and setting the procedures and policies for board directorships and the election process?

A. Risk committee.

B. Nomination committee.

C. Compensation committee.

The correct answer is **B.**

The nomination committee is responsible for setting the procedures and policies related to board directorships, including the nomination and election processes. This committee ensures that the process is conducted in a transparent and fair manner, adhering to the highest standards of corporate governance.

Therefore the nomination committee helps in maintaining a balanced and competent board, capable of guiding the company towards achieving its strategic objectives while upholding the interests of the shareholders.

**A is incorrect.** The risk committee is tasked with overseeing the company's risk management framework. Its responsibilities include identifying, evaluating, and managing the various risks that the company faces, such as financial, operational, strategic, and compliance risks. The committee ensures that the company has appropriate systems and controls in place to effectively manage these risks and safeguard the company's assets and reputation.

**C is incorrect.** The compensation committee focuses on developing and overseeing the company's compensation policies, particularly for its directors, senior executives, and key personnel. This includes setting performance targets, determining salary levels, bonuses, and other forms of remuneration, as well as overseeing the implementation of incentive schemes.

The committee aims to ensure that compensation practices are aligned with the company's strategic goals and governance principles, motivating key personnel to achieve high performance.

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Q.160 Which of the following statements regarding an audit committee is *least likely* accurate?

A. All members of the committee should be independent.

B. All members of the audit committee should be financial experts.

C. The audit committee is responsible for recommending and compensating external auditors.

The correct answer is **B.**

An audit committee oversees and ensures the effectiveness of audit and control systems in a company by monitoring the financial reporting process. It is comprised of independent non-executive (external) directors. Audit committee members are independent to prevent insider influence.

The audit committee:

1. Ensures that financial statements are ethically prepared and reflect the company's true financial position.
2. Ensures that a company's internal audit function is independent and competent.
3. Recommends the appointment of external auditors and their remuneration.
4. Analyzes the reported audit reports and advises a company on the way forward.

Not all members of the audit committee should be financial experts.

**A is incorrect.** Independence is a critical attribute for audit committee members, as it helps to ensure that the committee can perform its duties without undue influence from the company's management. Independent members are better positioned to provide objective oversight of the company's financial reporting processes, internal controls, and the external audit function. This independence is crucial for maintaining investor confidence in the integrity of the company's financial statements.

**C is incorrect.** The committee plays a vital role in the selection and oversight of the company's external auditors. By recommending the appointment of, and determining the compensation for, external auditors, the audit committee helps ensure that the external audit is conducted by a suitably qualified and independent firm. This responsibility is fundamental to the audit committee's role in safeguarding the integrity of the financial reporting process and ensuring that the external audit is conducted in a manner that is free from conflicts of interest.

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Q.161 Which one of these statements is *most accurate* regarding corporate governance?

A. Each board member should take action in the best interest of shareholders.

B. The compensation committee is responsible for recruiting management.

C. If all members of management are CFA charterholders, a company's code of ethics is not required.

The correct answer is **A.**

The primary responsibility of each board member is to act in the best interest of the shareholders. This principle is foundational to effective corporate governance. Board members are elected by the company's shareholders to protect their interests, provide strategic direction, monitor company and management performance, and ensure broad oversight.

They are bound by two critical duties: the duty of care and the duty of loyalty. The duty of care mandates board members to act with due diligence, in good faith, and to be fully informed before making decisions. The duty of loyalty requires them to prioritize the collective interest of the company and its shareholders above their own interests or the interests of any individual or group.

**B is incorrect.** The nomination committee is tasked with identifying and recruiting board members, such as senior directors. The responsibility of recruiting senior management lies with the board members themselves. The nomination committee plays a crucial role in ensuring that the board is composed of individuals with the necessary skills, experience, and integrity to effectively oversee the company's operations and strategy.

**C is incorrect.** This option erroneously implies that the presence of CFA charterholders in management negates the need for a company's code of ethics. Regardless of the professional qualifications or designations held by members of management, a code of ethics is essential for guiding the behavior and decision-making of all employees within the organization. A code of ethics serves as a formal statement of the company's values and principles, outlining expected standards of conduct and providing a framework for ethical decision-making and is a critical component of a company's governance and risk management practices.

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Q.1583 You have been hired to help streamline the corporate governance structure at Exim Bank. In the process, you have established several facts about executive remuneration at the bank. The remuneration plan you would be *most likely* concerned about is:

A. one that varies from year to year.

B. one that's consistent with the bank's competitors.

C. one that's wholly cash-based with no offer for equity or stock options.

The correct answer is **C.**

Option C, which involves a remuneration plan that is wholly cash-based with no offer for equity or stock options, is most concerning from a corporate governance perspective. A cash-only compensation structure for executives can lead to a misalignment of incentives between the management and the shareholders of the bank.

Equity-based compensation, such as stock options, aligns the interests of the executives with those of the shareholders, as the value of their compensation becomes directly linked to the performance of the company's stock.

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**A is incorrect.** A remuneration plan that varies from year to year can be beneficial as it allows for adjustments based on the company's performance, economic conditions, and other relevant factors. This flexibility can help ensure that executive compensation remains aligned with the company's success and strategic objectives.

Variable compensation plans often include performance-based bonuses, equity awards, and other incentives that can motivate executives to achieve specific goals that are in the best interest of the company and its shareholders.

**B is incorrect.** Having a remuneration plan that is consistent with the bank's competitors is generally not a cause for concern. Benchmarking executive compensation against industry peers can help ensure that a company's pay structure is competitive, which is important for attracting and retaining top talent.

Analysts and shareholders may become concerned if executive compensation significantly deviates from industry norms. This supports good corporate governance practices by ensuring that executive compensation is fair, competitive, and performance-based.

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Q.1586 Which of the following is *most likely* a board of a shareholder mechanism used to promote good corporate governance?

A. Bond indenture.

B. Employment contracts.

C. Shareholder derivative lawsuit.

The correct answer is **C.**

A shareholder derivative lawsuit is a mechanism that allows shareholders to take legal action on behalf of the corporation against insiders such as directors, management, or controlling shareholders for breaches of fiduciary duty. This legal tool is designed to address situations where those in control of the company may have acted against the interests of the company and its shareholders, potentially harming the company's value and governance structure.

By enabling shareholders to sue errant managers or directors, shareholder derivative lawsuits serve as a check on management and board actions, promoting accountability and good corporate governance practices.

**A is incorrect.** Bond indentures are agreements between bond issuers and bondholders that specify the terms of the bond, including the interest rate, maturity date, and other conditions. Bond indentures are primarily concerned with the relationship between the company and its creditors, not with promoting good corporate governance among the company's management or board of directors.

**B is incorrect.** Employment contracts are agreements between a company and its employees, including its executives. These contracts can include clauses related to performance, remuneration, and termination. While they can be used to align the interests of executives with those of the company, they are not specifically a mechanism for shareholders or the board to directly influence corporate governance. Employment contracts are generally more focused on individual employment terms rather than broader governance issues.

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Q.1588 Which of the following statements is *least likely* accurate regarding the audit committee?

A. All committee members must be financial experts.

B. The external auditor is free from the influence of the management.

C. Proper accounting and auditing procedures should always be followed.

The correct answer is **A.**

An audit committee oversees and ensures the effectiveness of audit and control systems in a company by monitoring the financial reporting process. It is comprised of independent non-executive (external) directors. Audit committee members are independent to prevent insider influence.

**Functions of the Audit Committee.**

The audit committee;

1. Ensures that financial statements are ethically prepared and reflect the company's true financial position.
2. Ensures that a company's internal audit function is independent and competent.
3. Recommends the appointment of external auditors and their remuneration.
4. Analyzes the reported audit reports and advises a company on the way forward.

At least one member of the audit committee should be a financial or an accounting expert.

**B is incorrect.** The statement that the external auditor is free from the influence of the management is a fundamental principle underlying the audit committee's function. The audit committee acts as a bridge between the company's management and its external auditors, ensuring that the auditors can perform their duties independently and without undue influence from the company's management.

This independence is critical for the credibility of the audit process, as it helps to ensure that the external auditor's opinions on the company's financial statements are objective and unbiased.

**C is incorrect.** The statement that proper accounting and auditing procedures should always be followed is a core responsibility of the audit committee. The committee is charged with monitoring the company's compliance with legal and regulatory requirements related to financial reporting and auditing.

This includes ensuring that the company follows generally accepted accounting principles (GAAP) or international financial reporting standards (IFRS), depending on the jurisdiction. By ensuring adherence to proper accounting and auditing procedures, the audit committee helps to prevent financial misstatements and fraud, thereby protecting the interests of shareholders and other stakeholders.

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Q.1589 Simon Segal is an investor of Insert.net Ltd who is currently evaluating board members and the remuneration committee. Which of the following is *least likely* an important element to analyze?

A. If the firm has provided loans to members.

B. If the terms of options granted are reasonable.

C. If the members are Chartered Professional Accountants.

The correct answer is **C.**

The remuneration committee:

1. Comes up with remuneration plans for the directors and key executives of a company to be reviewed by the board or shareholders.
2. Sets performance criteria for managers and evaluates the performances of the managers.
3. May establish remuneration policies.
4. Comes up with and implements employee benefit plans (retirement plans, insurance, pension, and severance benefits).

It is not a requirement for the members of the remuneration committee to be Chartered Professional Accountants.

**A is incorrect.** The provision of loans to members of the company is a significant element to analyze when evaluating the remuneration committee. This practice can raise questions about potential conflicts of interest and the financial integrity of the company.

It is crucial to ensure that any loans to members are made transparently, under fair terms, and in the company's best interest. Such transactions can have implications for the company's governance and financial health, making it an important area of scrutiny.

**B is incorrect.** Option grants are a common component of executive compensation packages and can significantly influence executive behavior and company performance. Evaluating whether the terms of these options are reasonable involves assessing their alignment with shareholder interests, their potential impact on risk-taking behavior, and their contribution to long-term company value.

Unreasonable terms can lead to misaligned incentives, excessive risk-taking, or undue rewards for executives, which are all concerns for investors and stakeholders.

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Q.1594 Which of the following is *most likely* focused on the clauses within lending agreements that detail the actions issuers are obligated to perform or prohibited from performing?

A. Covenants.

B. Collaterals.

C. Bond indenture.

The correct answer is **A.**

Covenants are specifically designed clauses within lending agreements that detail the obligations and restrictions imposed on issuers. These clauses are critical in defining the relationship between the lender and the borrower, as they outline the actions that the borrower is obligated to perform and those they are prohibited from performing.

The inclusion of covenants in lending agreements serves several purposes, including protecting the interests of the lender by ensuring that the borrower maintains a certain level of financial stability and operational integrity throughout the term of the loan.

**B is incorrect.** Collaterals refer to assets or financial guarantees that a borrower offers to a lender as security for a loan. The primary function of collateral is to provide the lender with a form of protection in case the borrower defaults on the loan. If the borrower fails to meet their obligations under the loan agreement, the lender has the right to seize the collateral and sell it to recover the outstanding loan amount.

**C is incorrect.** A bond indenture is a comprehensive legal document that outlines the terms and conditions under which a bond is issued. It includes a wide range of information, such as the interest rate, maturity date, repayment schedule, and, importantly, any covenants that apply to the bond issue.

While covenants are a critical component of a bond indenture, they are only one part of the broader set of terms and conditions contained within the document. The bond indenture serves as the contract between the bond issuer and the bondholders, establishing the legal framework for the bond issue.

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Q.1597 Which of the following documents can *least likely* provide information regarding the shareholders' sponsored board nomination?

A. Corporate bylaws.

B. Articles of organization.

C. Quarterly financial reports.

The correct answer is **C.**

Quarterly financial reports are the least likely source of information regarding shareholders' sponsored board nominations. These reports primarily focus on the financial performance of a company over a specific quarter, including its revenue, expenses, profit margins, and other financial metrics. They are designed to provide investors and other stakeholders with an up-to-date picture of the company's financial health and operational results.

**A is incorrect.** Corporate bylaws are a critical document in understanding the governance structure of a company, including the rights and responsibilities of shareholders, directors, and officers. They often contain specific provisions related to the nomination and election of board members, including any rights shareholders might have to nominate directors. This makes corporate bylaws a likely source of information regarding shareholders' sponsored board nominations.

**B is incorrect.** Articles of organization, also known as articles of incorporation in some jurisdictions, establish a company's existence and outline its governance structure, purpose, and initial directors, among other foundational details. While they might not detail the process of shareholders' sponsored board nominations as specifically as corporate bylaws might, they can still provide a legal framework that supports or mentions shareholder rights in this context. Therefore, they are also a more likely source of information on this topic than quarterly financial reports.

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Q.1600 Which of the following should you *most likely* analyze to evaluate if the legal rights of shareholders are protected under the corporate governance code and legal statutes of the jurisdiction in which the firm is headquartered?

A. Analyze if shareholders are allowed to sponsor the audit committee.

B. Analyze if members of the board possess the necessary experience.

C. Analyze if the legal statute allows shareholders to take legal actions to enforce ownership rights.

The correct answer is **C.**

To effectively evaluate if the legal rights of shareholders are protected under the corporate governance code and legal statutes of the jurisdiction in which the firm is headquartered, it is crucial to analyze if the legal statute allows shareholders to take legal actions to enforce ownership rights.

This aspect is fundamental because it directly impacts shareholders' ability to protect their interests and investments. The capacity to initiate legal action is a powerful tool for shareholders, ensuring that their rights are not infringed upon and that they have a recourse in case of disputes or violations of their rights.

**A is incorrect.** Analyzing if shareholders are allowed to sponsor the audit committee, while important for understanding aspects of corporate governance and shareholder influence, does not directly address the protection of legal rights of shareholders. The ability to sponsor an audit committee may contribute to transparency and accountability but does not provide a direct mechanism for shareholders to enforce their legal rights or take action against violations.

**B is incorrect.** Analyzing if members of the board possess the necessary experience is crucial for assessing the board's effectiveness and its ability to make informed decisions that benefit the company and its shareholders. However, the experience of board members, while important for overall corporate governance, does not directly relate to the legal mechanisms available to shareholders for protecting their rights.

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Q.1601 Takeover defenses are provisions that are used to make a firm less attractive. Which party is *most likely* deterred by such a move?

A. Regulators.

B. Shareholders.

C. Hostile bidders.

The correct answer is **C.**

Hostile bidders are individuals or entities that attempt to take over a company without the approval of its management and board of directors. Takeover defenses are specifically designed to deter these hostile bidders by making a takeover attempt more challenging, costly, or unattractive. Examples of takeover defenses include poison pills, staggered boards, and golden parachutes.

**A is incorrect.** Regulators are entities that oversee and enforce laws and regulations within various industries to ensure fairness, compliance, and protection of public interests. Takeover defenses are not aimed at deterring regulators. Instead, these measures are internal strategies employed by companies to ward off unsolicited takeover attempts. Regulators may review the legality and compliance of these defenses within the context of securities and corporate law, but they are not the target of such strategies.

**B is incorrect.** Shareholders are the owners of a company through their stock holdings. Takeover defenses are not designed to deter shareholders. While some shareholders may view takeover defenses as a way to protect their investment from undervalued acquisition offers, others may criticize these measures for potentially entrenching management and preventing shareholders from receiving a premium on their shares in a takeover scenario.

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Q.1602 Which of the following is *least likely* a provision of takeover defense?

A. Poison pills.

B. Proxy contests.

C. staggered board members.

The correct answer is **B.**

Proxy contests are not a form of takeover defense but rather a strategy employed during takeover attempts. In a proxy contest, a group of shareholders attempts to gain control of the company's board of directors by convincing other shareholders to vote for their slate of nominees. This strategy is typically used by an entity or group of investors seeking to make significant changes within a company, including taking over its management.

Proxy contests are initiated by outsiders aiming to gain control. Therefore, understanding the nature of proxy contests is crucial in distinguishing them from defensive strategies designed to protect a company from unsolicited takeover attempts.

**A is incorrect.** Poison pills are a common takeover defense mechanism. They are designed to make a company less attractive to potential acquirers by allowing existing shareholders (except the acquirer) to purchase additional shares at a discount, effectively diluting the shares of the acquirer and making the takeover more expensive and less appealing. This strategy is employed to protect the company and its shareholders from hostile takeovers that may not be in their best interest, ensuring that any change in control occurs on terms favorable to the existing shareholders.

**C is incorrect.** Staggered board members serve as another effective takeover defense. In a staggered board setup, board members are divided into different classes with different terms of office. Only a fraction of the board members are up for election in any given year, making it more difficult for a hostile bidder to gain control of the board quickly. This arrangement provides stability and continuity in the company's leadership and governance, protecting it from abrupt changes that could result from a hostile takeover attempt. By making it harder for an acquirer to replace the board and implement changes, a staggered board acts as a deterrent against unsolicited takeover bids.

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Q.3517 KKQ Chemicals Limited, a manufacturer of sodium bicarbonate, has operations in Western Europe. The company has been on an acquisition spree and has acquired ten small chemical companies in the last two years. While analyzing the company's filings, an equity analyst observes that the company has supervisory and management boards. Furthermore, he observes that the number of members serving on both boards is not restricted. The analyst is concerned about the acquisition carried out by the company. However, the management board

always discussed the proposal to acquire the companies and was subject to a shareholder vote at general meetings.
Which of the following statements is *most appropriate*?

A. The company's board composition is per corporate governance best practices.

B. The company's board composition is not per corporate governance best practices.

C. The presence of supervisory and management ensures discussion on proposals without undue influence from the company's shareholders.

The correct answer is **B.**

The company's board composition, which does not restrict the number of members serving on both the supervisory and management boards, is not in accordance with corporate governance best practices. Corporate governance frameworks typically advocate for a clear separation of roles and responsibilities between the supervisory and management boards to ensure an effective oversight mechanism.

This separation is crucial to prevent conflicts of interest and to promote transparency and accountability within the organization. By allowing members to serve on both boards, KKQ Chemicals Limited risks undermining the supervisory board's ability to provide unbiased oversight of the management board's decisions and actions. This arrangement could potentially lead to a lack of critical evaluation of management's proposals, including those related to acquisitions, and may compromise the board's effectiveness in safeguarding shareholders' interests.

**A is incorrect.** Best practices in corporate governance emphasize the importance of maintaining a clear distinction between the supervisory and management functions to ensure that the supervisory board can effectively monitor and evaluate the performance and decisions of the management board.

The presence of members serving on both boards blurs this distinction, potentially compromising the objectivity and effectiveness of the supervisory board's oversight role. Therefore, the company's board composition, as described, does not adhere to these principles.

**C is incorrect.** While it is true that having separate supervisory and management boards can facilitate focused discussions on company proposals, the primary concern here is not the influence of shareholders but the potential for conflicts of interest and lack of independent oversight due to overlapping membership between the two boards.

Shareholder influence, when exercised appropriately, is a vital aspect of corporate governance, providing a mechanism for accountability. The issue at hand is the structural setup that might hinder the supervisory board's ability to act as an effective counterbalance to the management board.

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Q.3945 Which of the following stakeholders' interests is *most likely* considered important compared to others under the shareholder theory?

A. Shareholders.

B. Debtholders.

C. Customers.

The correct answer is **A.**

Under the shareholder theory, the primary focus is on maximizing shareholder value. This theory posits that the ultimate goal of any corporation is to increase its stock price, which directly benefits its shareholders. The rationale behind this theory is that shareholders, being the owners of the company, have a vested interest in its financial success.

**B is incorrect.** Debtholders, such as bondholders or banks that have lent money to the company, have a different set of interests compared to shareholders. Their primary concern is the company's ability to meet its debt obligations, including interest payments and the repayment of principal.

**C is incorrect.** Customers are crucial to the success of any business, as they generate the revenue that the company needs to operate and grow. However, under the shareholder theory, the interests of customers are considered important only to the extent that they contribute to the company's profitability and, by extension, shareholder value. This theory does not advocate for sacrificing shareholder value to benefit customers.

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Q.4046 Which of the following statements regarding company-specific risks is *least likely* true?

A. Network effects can be a source of competitive advantage.

B. Execution risk can be accentuated by other business risks.

C. Competitive risk is lowered by the potential for disruption, such as using new technology.

The correct answer is **C.**

In reality, the introduction of new technologies or business models by competitors can significantly increase competitive risk for a company. Disruptive technologies can alter the competitive landscape by providing new or existing competitors with a means to offer superior products or services, potentially eroding the market share of companies that fail to innovate.

This form of risk is particularly pronounced in industries that are rapidly evolving or are highly susceptible to technological advancements. Companies must continuously innovate and adapt to new technologies to maintain their competitive edge and mitigate the risk of being outperformed by competitors leveraging disruptive technologies.

**A is incorrect.** Network effects refer to the phenomenon where the value of a product or service increases as more people use it. This can create a significant competitive advantage for companies that successfully leverage network effects, as it can lead to increased customer loyalty and barriers to entry for competitors.

Examples of companies benefiting from network effects include social media platforms, where the service becomes more valuable as the number of users grows, making it difficult for new entrants to compete. Therefore, stating that network effects can be a source of competitive advantage is accurate and does not represent the least likely true statement regarding company-specific risks.

**B is incorrect.** Execution risk involves the danger that a company's management will fail to implement business plans or strategies effectively, which can be exacerbated by other business risks such as market, credit, or operational risks. For example, a company aiming to expand into a new market may encounter unforeseen regulatory challenges or stronger than anticipated competition, which can compound the execution risk.

This interconnectedness of risks means that a failure in one area can have cascading effects on the company's overall risk exposure and performance. Thus, the statement that execution risk can be accentuated by other business risks is true and reflects a nuanced understanding of the complexities involved in managing company-specific risks.

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