Suggested answers and examiner’s comments

Corporate Governance

June 2014

Important notice

When reading these answers, please note that they are not intended to be viewed as a definitive ‘model’ answer, as in many instances there are several possible answers/approaches to a question. These answers indicate a range of appropriate content that could have been provided in answer to the questions. They may be a different length or format to the answers expected from candidates in the examination.

Examiner’s general comments

The general standard of answers in June 2014 has shown an improvement on the past, which may be a sign that corporate governance is becoming a more familiar topic for many. Successful candidates should be congratulated. However, for some answers, there were still familiar problems that have been commented on at some length in suggested answers and examiner’s comments in the past.

In this sitting, two problems seem to stand out. First, candidates did not always answer the question, but instead wrote in a general way around the subject. Marks are not awarded for points unless they are relevant to what is being asked. It is therefore important to focus on the specific requirements of the question, and to make sure that the marker can understand the relevance and validity of each point that is made.

Second, the answers showed that many candidates are not as familiar with some basic facts as perhaps they should be, which suggests that they may not have learned the syllabus in enough detail. In this June sitting, for example, a large proportion of candidates did not specify correctly the UK Corporate Governance Code provision on board composition relating to the number of non-executive directors. In answer to one of the questions, some candidates stated the composition of a nomination committee incorrectly, and the question also did not ask about the composition of the committee. In answer to another question, some candidates did not show awareness of the requirement in the Companies Act that public companies must have a company secretary.
There were also some good features to many exam scripts. The general standard of expression of ideas was quite good, and many candidates seemed aware of the need to express their ideas clearly. There seems to have been much less use of brief bullet points in answers than in previous sittings, which is encouraging. It is not possible to convey ideas sufficiently in a list of points where each point consists of nothing more than a brief phrase.

Candidates also appear to have been good at allocating their time between questions: there were not so many scripts as in the past where candidates had clearly rushed their fourth question (and as a result produced a final answer which earned few marks). I would like to think that candidates are now getting better at heeding warnings that have been made in the past.
Penn plc ('Penn') is a UK listed construction company that specialises in major infrastructure projects. A few months ago, it won a major contract in another country to construct a new power station for the government, and when this information was announced to the stock market, the share price rose by 5%. A recent report in the media, however, has alleged that Penn won this contract by paying substantial bribes to a number of government officials in the foreign country. The media report claimed that the information had come from an employee of the company who had been an observer of the contract negotiations.

The chairman called an unscheduled board meeting to discuss the matter, aware that several shareholders of Penn have already expressed their concern about the share price and the company's reputation. At this meeting, the chief executive officer (CEO) and finance director expressed their firm opinion that there had been no payments of bribes and that the media report was almost certainly false. Having obtained an opinion from the company's legal advisers, they did not expect any challenge to the validity of the contract with the foreign government, either from the government itself or from a rival company that had made an unsuccessful bid for the contract.

Two non-executive directors (NEDs) were not entirely convinced by the denials of the CEO and finance director, and were not reassured by the opinion from the company's legal advisers, which they felt had been given in too much of a hurry. They insisted on asking another law firm for an independent opinion of the legal risk in this situation.

The chairman asks you, as company secretary, to give your views to the meeting about the governance issues that have been raised and about the appropriate way forward for dealing with them.

Required

(a) Explain the law on bribery of foreign officials by UK companies and discuss the principles that companies should apply, when formulating their policies and procedures, to prevent bribery by their employees or agents.

(6 marks)

Suggested answer

The UK Bribery Act 2010 makes it an offence to offer or receive bribes, to bribe foreign public officials for commercial benefit or to fail to prevent a bribe from being paid on a company’s behalf. Bribery by a company is therefore a criminal offence, even when it occurs outside the UK. Guidance to companies from the UK Ministry of Justice promotes several principles:

- **Proportionate procedures.** Procedures to prevent bribery should be proportionate to the risk that bribery might occur and the scale of the company’s commercial activities. In the case of a company that undertakes major foreign projects, the potential risk of bribery is likely to be high.

- **Top level commitment.** Senior management should promote a corporate culture in which bribery is considered unacceptable.

- **Risk assessment.** There should be regular assessment by a company of the risk of potential bribery by people associated with it and how it might occur.

- **Due diligence.** Third party intermediaries and local agents acting on behalf of the company should carry out their own due diligence to identify and limit the risk of bribery.

- **Communication (including training).** Companies should seek to ensure that anti-bribery policies are communicated to employees and that employees should be given suitable training proportionate to the bribery risk that the company faces.
• **Monitoring and review.** There should be monitoring and review of anti-bribery procedures and any weaknesses identified by a review should be rectified.

**Examiner's comments**

Most candidates answering this question identified the Bribery Act as the source of the law, and provided a good explanation of the main terms of the Act. One or two excellent answers identified the UK Ministry of Justice guidance, but credit was given to sensible suggestions about principles that should be applied when developing policies and procedures for preventing bribery within a company.

(b) Advise the board of Penn how it should respond to the request from the two NEDs for an independent legal opinion.  

**Suggested answer**

The two NEDs have some concerns about the potential liability of the company for alleged bribery by company employees to win the overseas contract. They do not trust the reassurances provided to the board, which they think may be insufficiently well-considered.

My initial suggestion to the meeting would be to ask the CEO and the finance director to confirm their advice to the board that there is no legal threat or potential liability for the company, or to agree that further legal advice on the matter should be obtained. The board may be able to agree on this course of action.

If the board agrees to ask for further legal advice, this should be obtained without delay, because shareholders may be concerned about the implications of a legal dispute for the company’s future commercial prospects and profitability. The share price went up by five per cent on announcement of the news of winning the contract. It could fall back again if shareholder confidence is lost.

If the CEO and finance director cannot agree that further legal advice is necessary, the chairman should ask the two NEDs whether they are prepared to accept the assurances they have been given that there are no legal concerns. If they are unwilling to do this, I would suggest that the reasons for their concerns should be recorded in the minutes of the meeting.

I would then go on to advise that a provision of the UK Corporate Governance Code (UK Code) is that directors should have access to independent professional advice at the company’s expense if they consider this necessary for them to discharge their responsibilities as directors. If the NEDs are insistent on obtaining further legal advice and are willing to let their reasons be recorded in the minutes, I would advise that this course of action is appropriate.

However, it would make more sense for the board to agree to this course of action collectively. Any legal advice obtained would have to be made available to the entire board.

**Examiner's comments**

A large proportion of candidates did not show awareness of the provision in the UK Code about directors having the right to seek independent professional advice at the company’s expense in order to discharge their duties. However, a number of candidates gave thoughtful answers about the responsibilities of directors to their company and, without knowing the UK Code provision, came to a well-argued conclusion.

Weaker answers simply stated that the NEDs should be allowed to obtain an extra legal opinion, without explaining why. Some candidates suggested that the original legal advice may have come from lawyers who were not independent and who (for whatever reason) were probably biased. Lawyers are professionals and a part of their ethical code is to behave at all times with objectivity.
(c) Make recommendations about any other issues that you consider the board should address with regard to internal control and measures it should take to deal with the problems that have arisen.

(12 marks)

**Suggested answer**

The Bribery Act 2010 makes it an offence for a company to fail to prevent bribery by any of its employees or agents. However, a company can avoid conviction for failing to prevent bribery if it can show that it has ‘adequate processes’ in place to prevent bribery, even though bribery has occurred. Given the nature of Penn’s business, which involves winning major construction projects in competition with other companies, high standards of internal control to prevent bribery are required.

I would make two recommendations to the meeting. Both relate to the company’s internal control system.

The first recommendation is that if the company has been guilty of giving bribes to government officials in another country, there has presumably been a bank transaction, or a series of bank transactions, for the payments of the bribes. The finance director should be asked to check whether there have been any unaccountable payments or transfers of money that might give rise to suspicion.

For the future, the board must be satisfied that the company has an effective system of internal control that prevents payments of bribes. It must also be able to demonstrate to investigators, if required, that its controls are robust and effective. Although the executive management has direct responsibility for the enforcement of internal controls, the board has a responsibility to monitor the effectiveness of the internal control system.

A provision of the UK Code is that the board, at least annually, should conduct a review of the company’s internal control system. This review should cover financial, operational and compliance controls. The responsibility for carrying out the review may be delegated to the audit committee, but the committee would have to report to the board on its findings. In view of the concerns about the allegations of bribery, this should be a matter of urgency.

The media report alleging bribery claims that the story came initially from a ‘whistle-blower’ who works for Penn. If this story is true, there should be serious concern about why an employee felt it necessary to disclose his or her concerns to the media and not through the company’s internal whistle-blowing system. There would have to be a suspicion that the whistle-blowing system is ineffective and does not encourage employees to report their concerns in confidence or reassure them that they will not be victimised for making allegations.

Another provision of the UK Code is that the audit committee should review whistle-blowing arrangements that enable staff in confidence to raise concerns about possible improprieties. There should be arrangements in place for proportionate and independent investigation of such matters and for appropriate follow-up action.

Having suitable whistle-blowing procedures could be a sufficient defence against a criminal charge of failing to prevent bribery, provided that the company can demonstrate that the procedures work well in practice. It is not sufficient simply to have a whistle-blowing policy in existence, but which no one uses.

It is quite possible that in this case there has been no bribery and no improper behaviour, in which case there would have been no reason to expect allegations from a whistle-blower. However, the audit committee should be asked to review the effectiveness of the whistle-blowing arrangements in Penn and report to the board on its findings.
Examiner’s comments

This part of the question carried the most marks, but some answers lacked ideas, or did not explain relevant ideas clearly or sufficiently. For example, some candidates discussed the need to review the whistle-blowing system (or the need to have such as system), but dealt with this valid point in just one brief sentence.

Other candidates referred to the need to have an internal control system. All organisations have an internal control system of some sort. The required point was that the effectiveness of aspects in the system should perhaps be reviewed, and not that a system should be established where none existed before.
Hink Limited (‘Hink’) is a successful family-run business. The board of directors is led by the founder of the company, John Hink (‘John’), who is both chairman and chief executive officer (CEO). The other board members, a finance director and two non-executive directors, are also John’s brother and daughter. The members of the Hink family own all the share capital of the company. The company does not have a company secretary, and its auditors are a local firm of accountants in the town where Hink has its head office.

John is proud of his entrepreneurial success. He has been prepared to take big risks with the company’s strategy in order to grow the business and, when necessary, he has been willing to cancel the annual dividend to shareholders to spend money on investment or to accept temporary decline in profits for the sake of longer-term success. He is aware that the company does not have a good reputation as an employer, but he believes that the company exists for the benefit of the Hink family and employees should be grateful to have their jobs.

John wants to retire in a few years’ time. He would like his daughter to take over the running of the company, but he would also like to take the company public and get it accepted on to AIM, the junior stock market in the UK. He is aware that the governance of the company will have to undergo substantial change for this to happen, but he does not want to retire until all the changes have been made and the company’s shares are being traded on AIM. He also knows that AIM companies are not required to comply with the UK Corporate Governance Code but are, nevertheless, expected to have high standards of governance.

Required

(a) Explain how the board’s attitude to its shareholders and other stakeholders will need to change if Hink goes public.

(10 marks)

Suggested answer

When a company changes its status from private to public, its shares can be purchased by the general public. If the company’s shares are accepted for trading on AIM, the junior stock market in the UK, external investors will certainly buy shares in the company.

Changes in the ownership of the company will have important implications for Hink, which is currently 100% owned by family members. The board of directors will be expected to act in the best interests of the shareholders as a whole, and cannot act in the interests of the family members if this is to the detriment of the other shareholders.

The agency theory of corporate governance suggests that there is a potential conflict of interests between a board of directors and the shareholders, which is at its worst in public companies with external shareholders.

The conflict between the interests of board members and the shareholders will depend to some extent on the composition of the board, and could take several forms. In the past the board of Hink has been prepared to make short-term sacrifices, such as cancelling the annual dividend, in order to invest in long-term growth for the business. External shareholders may expect much more certainty about annual dividends, and may be hostile to a dividend decision by the board. The board has also been prepared to take strategic risks in order to grow the business: shareholders in a public company may expect the board to limit its risk appetite so that shareholders’ interests are not exposed to excessive risks.

If any Hink family members remain on the board after the company goes public there may be some risk that these family members will continue to treat the company as an extension of their own private assets, and incur excessive expenses in support of a lavish lifestyle. Another potential risk is that family members, having secured personal wealth by selling their shares to external investors, may no longer put in the same amount of effort to their work as they did previously when the company was private.
All these concerns will inevitably mean that shareholders will demand changes to the composition of the board, so that there is a strong independent element among the board members.

If the company goes public, there may be a change in the expectations of the workforce. Hink does not have a reputation as a good employer, and so probably does not have formal policies on social and employment matters. There is no evidence that Hink acts unethically, but employees (and external shareholders) may expect the company to demonstrate ethical conduct in the future. The board may therefore wish to consider the development of a corporate code of ethics, or to consider new initiatives such as employee share option schemes or more generous employee benefits, for example, a pension scheme, in order to demonstrate greater concern for employees as well as strengthen employee loyalty.

There will also need to be a change in relationship between the ‘old’ directors who were on the board when the company was unquoted (and remain as directors) and the newly-appointed directors, in particular, any independent non-executive directors. Independent directors should seek to ensure that the board acts in the best interests of the company as a whole, and may therefore challenge some of the established views of the ‘old’ board members.

**Examiner’s comments**

The key to a good answer here was to recognise that, by going public and selling some shares to the general investing public, the company would no longer be a family company where all the shares were owned by family members and family members held the board positions.

There were some excellent answers. However, candidates did not answer the question well if they did not recognise the difference between a private family company and a company with shares quoted on AIM. In search of ideas, some candidates made points in this answer that were more appropriate to part (b).

(b) Giving your reasons, identify the main aspects of governance that the board of Hink will have to consider before the company goes public, and suggest changes that will have to be made.

*(15 marks)*

**Suggested answer**

If the company goes public, and if its shares are accepted for trading on the junior market, it will not be required to comply with the provisions of the UK Corporate Governance Code, which applies only to listed companies. However, the company will be expected to demonstrate a minimum standard of good corporate governance, and a variety of changes will be necessary.

The composition of the board must change. The current board consists of four directors, two executive and two non-executive directors, but the non-executive directors are not independent. External investors will expect the membership of the board to have a suitable range of skills and experience to provide effective leadership to the company. There will also be a requirement for independent non-executive directors. It may be appropriate to increase the size of the board above its current number of just four. It also seems likely that one or both of the current non-executive directors will be expected to resign, because of their family interests. John may retain his dual role as CEO and chairman in the short term but, in time, investors will probably expect these two roles to be held by different individuals.

John would like his daughter to succeed him in running the company, but it is not clear that she has the experience or ability to do this successfully. It could be acceptable for family members to serve as members of the same public company board, but shareholders would need reassurance that this is in the best interests of the company.
Since major changes would be required to the company’s board, it may be necessary to introduce the changes gradually instead of all at the same time, so that the company is not disrupted by a radical change in its leadership.

Hink will be expected, as a matter of good governance practice, to establish board committees, even though there is no legal requirement or code requirement for such committees (except for listed companies). An audit committee would have responsibility for monitoring the quality of the external audit as well as the effectiveness of the internal control system. A remuneration committee should provide some reassurance to shareholders that executive directors are not in a position to make decisions about their own remuneration. In the longer term, a nomination committee will also reassure shareholders that the skills and experience of board members will be kept under review and that a succession plan will be developed.

If the company appoints any executive directors who are not members of the Hink family, it is probable that these individuals will expect the company to establish formal arrangements and procedures for both annual bonuses and longer-term incentives, such as a share grant scheme. If incentive schemes are created for executive board members, the board may also wish to consider a broader scheme for other employees below board level.

The company currently uses a local firm of accountants as its auditors. This may be reviewed, although an audit committee (assuming that one is established) should be asked to consider the matter and make a recommendation to the board.

There is no requirement for a non-listed company to have a company secretary. However, in view of the increase in administrative requirements and governance issues that will occur as the company joins the junior market, it may be appropriate for the company to appoint a full-time or part-time company secretary.

The board will have to consider its relations with shareholders, and the way in which the company reports on its performance and future prospects. The company will be required to provide more extensive information to shareholders than it probably has done in the past. For example, it may need to provide more information about the going concern status of the company and the company’s performance, situation and future prospects in an annual strategic report/business review. Hink may not have held annual general meetings in the past, but this will no longer be the case.

Examiner’s comments

Again, some answers to this part of the question were very good. Many candidates recognised that this question invited a discussion of all the aspects of corporate governance that would need to be considered by a company whose shares are about to be quoted on AIM. Some candidates did not identify the reference to AIM and so wrote about the UK Code of Corporate Governance: this was treated as a minor error in the marking plan.

Some answers included incorrect and ill-judged comments. Not all answers recognised that public companies in the UK should have a company secretary. Some candidates, in discussing a change of auditors, asserted that the current auditors would be too familiar with the company and would lack independence. Professional accountants are required by their code of ethics to maintain their independence and to beware of familiarity risks and other risks to independence. Better answers suggested that the current auditors may be too small to act as auditors of a quoted company, and a change of auditors to a larger firm should be considered.

A number of candidates suggested that a number of independent NEDs should be appointed to the board and a nomination committee should be set up for this purpose. They did not suggest who the committee members might be, given that the company did not yet have any independent NEDs at all. It also appeared that some candidates discussed more or less everything they could think of that might be relevant to the question. Suggestions that the company should consider at this stage establishing a risk committee were not well considered, and suggestions that the board should develop a CSR policy at this stage also seemed rather premature.
Blotter plc (‘Blotter’) is a listed UK company in the FTSE 350. Colin Dott (‘Colin’) is the Chief Operations Director and a member of the board of directors. Colin owns a building that Blotter leases. The lease of the building is now due for renewal and renegotiation, and Colin is asking for a substantial increase in the lease rental. Some shareholders of Blotter (all of them UK institutional investors) have expressed their concern about the fact that Blotter may continue to use a building owned by one of its executive directors. The concerned shareholders have so far been unable to persuade the company chairman to take action to prevent the lease from being renewed. However, the chairman is considering how he should respond to the concerns of the shareholders without creating unnecessary problems for the company and its board.

Required

As company secretary, write a report to the chairman of Blotter that deals with the following issues.

(a) Explain the legal responsibilities of directors of UK companies with regard to transactions with companies in which they have a personal interest.

(8 marks)

Suggested answer

To: Board Chairman
From: Company Secretary
Date: 5 June 2014

Subject: Shareholder concern about lease renewal

This report explains some of the issues relating to the proposed renewal of the lease on the property owned by Colin, the Chief Operations Director, considers actions that discontented shareholders may take and recommends actions that you may wish to take as chairman to deal with the matter.

Directors have certain responsibilities to their company under the provisions of sections 171 – 177 of the Companies Act 2006. Two of these may be particularly relevant with regard to transactions with the company in which the directors have a personal interest.

Directors have a duty to avoid conflicts of interest with the company. Colin has an interest in the property transaction with the company, but this does not necessarily conflict with the interest of the company. The company may need premises in which to operate and, if so, the premises owned by Colin may be suitable and appropriate. Colin is also trying to increase the rental substantially.

Without further information, it is not possible to assess whether Colin is trying to persuade the company to renew a lease on a building that is inappropriate and too expensive, and this is a matter that the rest of the board should consider.

Directors have a duty to declare their interest in any proposed transaction with the company. In this situation Colin has declared his interest in the property to the board, and he has therefore complied with the legal requirement. It should be for the rest of the board to decide whether to renew the lease, and Colin should be asked to leave the boardroom when the board considers the issue. The matter should be considered formally by the board.

The Disclosure and Transparency Rules (DTR) require listed companies to make an announcement of any related party transaction with the company involving a director, and obtain shareholder approval. However, related party transactions do not apply to transactions in the normal course of business (‘transactions of a revenue nature’) and a lease agreement on a business property would therefore not be a related party transaction.
Examiner’s comments

Most answers recognised that this question dealt mainly with directors’ duties and included relevant comments. Very good answers recognised the DTR requirements.

The main problem in many answers was not making a distinction between avoiding a conflict of interests and disclosing interests in a transaction to the board. A director may have interests outside the company and may therefore be involved in a transaction with the company. This transaction need not create a conflict of interests, although it might. The director should inform the board, and it is for the board to decide whether the transaction is acceptable, or whether a conflict of interest exists – in which case appropriate measures must be taken to end the conflict.

(b) Suggest the actions that shareholders in a listed company may take if they are dissatisfied with a board’s response to their concerns and, as institutional investors, they follow the guidance of the UK Stewardship Code.

(11 marks)

Suggested answer

The UK Stewardship Code requires that institutional investors should monitor the companies in which they invest, in order to decide when it is appropriate to enter into an active dialogue with the board of directors. They should try to identify a problem at an early stage. In this situation, if an institutional shareholder thinks that the lease on the property is a matter of concern it should try to enter into a dialogue with the board before the lease agreement is signed.

Institutional investors should have clear guidelines about the circumstances when they will intervene actively. They must not get involved with detailed operational matters. The investors’ guidelines may, however, call for intervention when there is a suspicion of a conflict of interests for a member of the company’s board.

If the company’s board does not respond constructively, the institutional investor should have guidelines for deciding whether and how to escalate their action. For example, an institutional investor may express their concern to the company’s financial and stock market advisers, ask for a meeting with the company chairman, or find out whether other institutional shareholders share the same concerns so that joint action can be considered. If they consider the matter to be very serious, they may choose to make a public statement of their opposition to what the board is proposing to do.

The Stewardship Code also states that institutional shareholders should be willing to act collectively with other investors where appropriate.

The Stewardship Code also states that they should seek to vote all the shares that they hold and, if they have a strong objection to any action taken by the board of a company, they should consider using their votes to register their opposition. Voting should be consistent with the voting policy of the institutional investor organisation, and any intention to vote against the board at an annual general meeting (AGM) should be notified to the board chairman in advance.

Examiner’s comments

Some answers to this question were not well structured, beginning with a suggestion that shareholders should vote against ‘the resolution’ or should vote against the re-election of the board or should call an emergency general meeting (EGM), and were then followed by a comment about the need for dialogue and a gradual escalation of actions.

Candidates who wrote about voting against ‘the resolution’ did not indicate what resolution they had in mind. Unless required by the DTR (if it is a related party transaction), the renewal of the lease would not be a matter for the shareholders to vote on.
(c) Describe the governance responsibilities of the chairman of a listed company with regard to the company’s shareholders.

(6 marks)

Suggested answer

The UK Corporate Governance Code (UK Code) contains a number of principles and provisions relating to the company chairman and the shareholders. The chairman should ensure that communications with the shareholders are effective. It also states as a principle that there should be dialogue with shareholders based on mutual understanding of objectives. A provision of the UK Code is that the chairman should ensure that the views of shareholders are communicated to the rest of the board and the chairman should discuss governance issues with major shareholders.

The chairman plays a significant role between the board and the institutional shareholders who have expressed concern. The board should understand the need to ensure that there is no conflict of interest for Colin and that any decision about the renewal of the property lease will be taken in the commercial interests of the company. The chairman should communicate the views of the board, and the reasons for their views, to the shareholders.

Another principle of the UK Code is that the company should use the AGM to communicate with investors and encourage their participation. Although this does not mention the chairman specifically, the chairman leads the board and is primarily responsible for this aspect of the UK Code. The FRC Guidance on Board Effectiveness states that the chairman should provide ethical leadership.

Examiner’s comments

The purpose of the question was to test understanding of the chairman’s role in communication with shareholders and achieving constructive dialogue. Some candidates did not mention these points at all and wrote about the chairman’s role in the company, or the chairman’s responsibility to ensure that the needs of shareholders were met. This was missing the point of the question.
Pastells plc (‘Pastells’) is a UK listed company (in the FTSE 350). It has been given a substantial fine by a court for a serious breach of environmental regulations and, in the same month, the company reported that it had suffered large losses as a result of unauthorised dealing in financial derivatives by a manager in its treasury department. As a result of these losses, the company’s reported profits for the previous financial year were overstated. Questions have been raised in the financial press about the financial stability of Pastells and there has been speculation that it will soon be the target of a takeover bid from a multinational competitor.

The chairman of the audit committee of Pastells has resigned, accepting responsibility for failures by the committee. A newly-appointed director has been made chairman of the audit committee. He has called a meeting with the finance director and you, the company secretary. The purpose of the meeting is to review financial reporting and internal control, with a view to making recommendations to the board at the next board meeting. Pastells does not have an internal audit function and the company has been using the same firm of external auditors since it acquired its listing eight years ago.

**Required**

(a) Explain the role and responsibilities of the audit committee of Pastells with regard to:

(i) the external audit of the company’s financial statements; and

(ii) the internal control system and internal audit function.

*(15 marks)*

**Suggested answer**

**External audit**

The UK Corporate Governance Code (UK Code) lists the following responsibilities of an audit committee with regard to the external audit.

The audit committee should monitor the integrity of the company’s financial statements. This requirement means that the audit committee has responsibilities with regard to the external audit. The FRC Guidance on audit committees states that at the beginning of the annual audit cycle, the committee should satisfy itself that an appropriate audit plan is in place. The committee should then, in consultation with the auditors, review the findings of the audit. At the end of the audit cycle it should assess the effectiveness of the audit. This assessment should include giving consideration to the way in which they have treated key accounting judgements and also obtaining feedback about their conduct from people within the company such as the finance director.

The UK Code also states that the audit committee should make recommendations to the board in relation to the appointment, re-appointment or removal of the company’s external auditors, whose annual appointment is put to the shareholders for approval in general meeting of the company. The committee should also approve the remuneration and terms of engagement of the external auditors that have been negotiated with the auditors by management.

The audit committee should also review and monitor the independence of the external auditors, and also the objectivity and effectiveness of the audit process. With regard to auditor independence the committee should also develop and implement the company’s policy on using the external audit firm for non-audit work, consistent with the ethical guidelines of the auditing profession.

In the case of Pastells, the audit committee should review the reasons why the fraud by the employee in the treasury department was not identified, and whether the external auditors may have been at fault in any way in failing to identify the problem. Although the auditors do not have responsibility for preventing and detecting fraud, they might be expected to identify and report suspicions of fraud that are uncovered during the course of the audit.
The UK Code requires FTSE350 companies to put the external audit out to tender every ten years, and this may therefore be an appropriate time to assess the company’s use of the current auditors and put the audit out to tender.

**Internal control system and internal audit function**

The UK Code states that the audit committee should review the company’s internal financial controls and, unless addressed by the board as a whole or by another board risk committee consisting of independent directors, it should also review the company’s internal control system.

If the company does not have an internal audit function, which is the case with Pastells, the audit committee should consider each year whether there is a need for such a function and make a recommendation to the board. The reasons for not having an internal audit function should also be explained in the report of the audit committee to the shareholders in the annual report.

The audit committee should also review the adequacy of the whistle-blowing arrangements in the company.

**Examiner’s comments**

The quality of answers varied according to the extent to which candidates appeared to understand the topic. In general, the weakest answers were those that did not explain points clearly. Weaker answers also omitted a large number of relevant points, described at some length the composition of an audit committee (which was not relevant to the question) or compared the responsibilities of an audit committee and a risk committee (which was also not relevant).

In their answers on internal control and the internal audit function, some candidates did not show understanding of the difference between an internal audit system and internal controls. Some candidates described the elements of an internal control system (which was not relevant). Others overlooked the statement in the question that Pastells did not currently have an internal audit function. A few candidates asserted that the internal control system could not be effective unless the company had an internal audit function, without explaining their reasoning for this assertion.

(b) With regard to the probable failures in internal controls that have occurred, suggest the changes that might be recommended to the board of Pastells at the next board meeting.  

(5 marks)

**Suggested answer**

Pastells has experienced two events that could be attributable to weak internal controls. The fine for breach of environmental regulations may be due to failure by company employees to apply appropriate procedures, or there may be inadequate procedures within the company to ensure compliance with the regulations. The fraud by the employee may have been made possible by lax financial controls, and possibly also inadequate whistle-blowing procedures that encourage employees to report suspicions of wrongdoing in confidence.

The adequacy of the company’s internal controls should therefore be reviewed as a matter of some urgency. It is possible that the audit committee has failed in its responsibilities in this respect, but the board may be prepared to allow the new chairman of the audit committee to lead the investigation. The investigation should be conducted by individuals who are independent of operational management. Since the company does not have an internal audit function, it may be appropriate to appoint a firm of external accountants to carry out the investigation.

The audit committee should also be asked to review, in the light of any failings in internal control, whether the company should establish an internal audit function.
Examiner’s comments

Most candidates made one or two suggestions for changes. Far too many answers suggested the need for a risk committee. Outside banks, risk committees of the board are not common.

(c) Suggest the other issues that the new chairman of the audit committee of Pastells should consider, in order to improve the performance of the audit committee and reassure the company’s shareholders about the financial prospects of the company.

(5 marks)

Suggested answer

The profits for the previous year were over-stated. Management must establish what the actual profit should have been and the board should arrange for this information to be audited and then reported to the stock market.

It is possible that the audit committee has failed to fulfil its responsibilities adequately, although the former chairman of the committee has now resigned. The chairman of the audit committee should consider whether the other members of the audit committee should be replaced. This might require changes to the membership of the board, and the audit committee chairman should therefore discuss this matter with the board chairman and, if a different individual, the chairman of the nomination committee.

Shareholders will be aware of the fine paid by the company and will also be aware of the incidence of fraud because the company would have to make an announcement about the review of its financial statements for the previous year. Shareholders should be concerned about these incidents, and will want to know what the company is doing to improve its internal control system. The chairman of the audit committee should consider what information should be given to shareholders in the next annual report. In the meantime, the company should consider meeting with major shareholders in order to inform them about measures that are being taken to improve the control system. (Note: This should be permissible since such information is not ‘inside information’ and discussing controls with shareholders would not make them insiders.)

The new audit committee chairman should also be prepared to address shareholders at the AGM in connection with these matters and the steps taken by the audit committee and the board to minimise the risk of further incidences.

Examiner’s comments

This question, worth a maximum of 5 marks, was not well answered by most candidates. A majority of answers did not address the question set. The question asked about issues to consider for improving the performance of the audit committee, but candidates suggested actions that would not affect the audit committee’s performance in any way. Very few answers made any comment at all about reassuring the company’s shareholders.
5 Nibb plc (‘Nibb’) is a UK listed company in the travel industry which has recently extended the range of its direct operations by acquiring a small airline company for taking customers to holiday destinations throughout Europe. Jeffrey Cole (‘Jeffrey’) is the newly-appointed chairman of Nibb. He is aware that, of the nine-member board of directors, three non-executive directors (NEDs) have all nearly reached the end of their second three-year contract term with the company.

Jeffrey is concerned about the quality and effectiveness of the board of directors of Nibb. He thinks that the board may be failing to give the company the strategic leadership that it needs and is worried that the company’s future may have been put into doubt by its failure to develop a system for selling its travel packages online. He suspects that the NEDs have not been sufficiently forceful in challenging the views of the executive management team.

He is convinced that urgent measures are required to review the composition of the board, but he is also aware of the need to ensure that any newly-appointed NEDs will require effective induction to the company. Some of the executive directors, including the chief executive officer (CEO), are also probably in need of training in areas such as online marketing. William Stone, the CEO, has already expressed the view that training will be wasted on him as he plans to retire in the next year or so.

Jeffrey has asked you, as company secretary, for your opinions and recommendations about board nominations and induction and training for directors.

Required

(a) Explain the principles and provisions in the UK Corporate Governance Code about the composition of the board of directors and induction and training for directors. 

(7 marks)

Suggested answer

A main principle of the UK Corporate Governance Code (UK Code) is that the board should have an appropriate balance of skills, experience, independence and knowledge of the company to enable it to discharge its duties and responsibilities effectively.

A supporting principle is that it should be of sufficient size that the needs of the business are met and that changes to the board can be made without causing undue disruption. However, the board should not be so large as to be unwieldy.

The board should contain a combination of directors such that no individual or small group of individuals can dominate decision-making.

There are several provisions in the UK Code relating to the composition of the board. The board must identify in its annual report those NEDs that it considers to be independent. Except for smaller companies at least half the board, excluding the chairman, should consist of independent NEDs. (A smaller company should have at least two independent non-executives.)

Another main principle of the UK Code is that all directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge. The chairman should ensure that directors continually update and refresh their skills and knowledge and the company should make available the resources for doing this. For this purpose, all directors must have appropriate knowledge of the company and access to its operations and its staff.

Provisions of the UK Code in support of these principles are that the chairman should ensure that new directors are given full, formal and tailored induction and that he or she should regularly review and agree with each director their development and training needs.
Examiner’s comments

Candidates attempting this question should have scored high marks, and many did. On the other hand, there were also some weaker answers.

Most candidates did not accurately state that at least half the board (excluding the chairman) should consist of independent NEDs. Some candidates stated that the board should be exactly 50:50 between executives and non-executives. Most answers did not include the word ‘independent’. Some NEDs are not independent, and the UK Code provision relates to independent NEDs.

Many answers simply did not include enough points on board composition.

In commenting on induction and training, some candidates wrote about ‘induction training’ and did not show awareness of the difference between induction and training. Although the question asked about the principles and provisions of the UK Code, quite a number of candidates wrote at some length about what induction might consist of, a topic more relevant to part (c) of the question than part (a).

Describe the nature of succession planning for a board of directors and recommend how Jeffrey should develop and implement a plan for changing the composition of the board of Nibb. (12 marks)

Suggested answer

Succession planning is a process of giving consideration in advance to changes that should be made to the board and, where possible, taking measures to prepare for these changes. Succession planning is commonly associated with the most senior board positions (chairman, CEO and finance director), but planning for change is appropriate for all board positions and for the composition of the board as a whole. The essential feature of succession planning is that it should be a forward-looking process. New board appointments should not be a short-term reaction to a vacancy on the board when it arises.

Jeffrey is both the board chairman and the chairman of the nomination committee, so he should take the lead in organising succession planning. The members of the nomination committee may give initial consideration to succession planning, but it should consult with other members of the board, major shareholders and any other stakeholders or executives whose views may be helpful.

A company should always keep under review the likely future successors to the positions of chairman and CEO. In view of the planned retirement of William Stone, the CEO, in the next year or so, Jeffrey and the nomination committee should establish exactly when the CEO will be retiring and try to identify a successor. The successor may be an internal or external appointment. If this search has not yet been started, it is an issue that should be given priority by the committee.

The nomination committee may also carry out regular reviews of the composition of the board, and report to the board on recommendations for changes in the future.

The UK Code states that there should be progressive refreshing of the board. An effective board can be maintained through planning for the continual refreshing of the board to bring in new skills and experience. The search for board candidates should be conducted, and appointments should be made, on merit. The UK Code also specifies that the search for new board members should have due regard for the benefits of diversity on the board, including gender.

Although Jeffrey should provide the leadership for succession planning, he must not be involved in planning for his own eventual succession as chairman and should not chair the nomination committee when it meets to consider this matter.
As well as planning the overall composition of the board, the nomination committee may also make recommendations about when the changes should be made. Alternatively, the board as a whole may discuss the timing of changes. NEDs are usually appointed for a term of three years, which may then be renewed for a further three-year period. The board should give careful consideration to whether extending an appointment for a further three-year period is appropriate, and the independence of a NED must be called into question when he or she serves on the board for more than nine years. Changes to the NED membership of the board may be timed to coincide with the end of the three-year term for existing NEDs.

When the board has established when changes may be required, it may authorise the nomination committee to take initial steps to identify potential new appointments to fill the future vacancies. The nomination committee may prepare a description of the role and capabilities that will be required for any particular appointment. An external firm of head hunters may be asked to carry out a search for potential recruits to the board, in particular a new CEO, bearing in mind the time frame and when the vacancies are expected to arise.

**Examiner’s comments**

A large majority of candidates attempting this question did not attempt to describe the nature of succession planning, and may have assumed that the answer was obvious and did not need stating.

A large number of candidates suggested that the company should set up a nomination committee, however, as a UK listed company, Nibb should already have one.

In general, there was little attempt to discuss planning for changing the composition of the board. Answers tended to list different points in a disjointed and unstructured way. Some wrote mostly about the process of identifying potential candidates for appointment to the board, which was only incidental to the issue of planning board changes. The best answers were those recognising that succession planning is most important for the top board positions and that for other board positions it is necessary to recognise that over time the balance of skills and experience required on the board will change, as the business environment in which the company operates also changes.

(c) Recommend measures to Jeffrey for the effective induction and training of board members, with a view to improving the effectiveness of individual directors of the company.

**Suggested answer**

The UK Code requires that all directors should have appropriate knowledge of the company. This may be a more important requirement for non-executives when they are first appointed to the company than for executive directors who may be appointed internally from the ranks of the senior company executives. However, executives appointed from outside the company will also need induction to learn about the company itself, even if they already know the industry. Induction for directors should be formal and tailored. Formality might be established by creating a document that sets out the induction process for a director. This should be formulated in discussion with the individual director, to make sure that it is tailored to the needs of the individual. Although the board chairman is responsible for ensuring that induction is provided, the task of organising induction may be delegated to the company secretary, who should subsequently report back to the chairman.

The induction process should be a combination of measures that are put together to meet the specific needs of the individual. It will include providing documents for the individual to read, such as minutes of past board and committee meetings, arranging site visits and meetings with managers and employees of the company. The induction process may need to be spread over a period of time, to give the individual time to absorb the information that is provided.

Like induction, training and development for directors should be tailored to the requirements of the individual. It may be appropriate for the chairman to consider training and development at the same time as the annual performance review of the board, its committees and its individual directors. The
need for training may also depend on changes to technology in the company’s industry or changes in relevant laws and regulations. The chairman should discuss training and development requirements with each director, and this may be discussed when each director is given feedback about his or her annual performance review.

Examiner's comments

Most candidates wrote sufficient for a satisfactory answer but very few provided an excellent answer. Some candidates provided short bullet point lists of matters to include in the induction of a new director, and many answers did not mention ongoing training.
You are the company secretary of Kwill plc ('Kwill'), a UK listed multinational company with global mining operations. The chairman of the company, Francis Goody ('Francis'), is also the chairman of a large charity organisation, and has asked you to brief him on corporate social responsibility (CSR) issues.

Required

Prepare a briefing note to Francis covering the following points.

(a) Define ‘conscience of the company’ and suggest what a company secretary might do to fulfil this role.

Suggested answer

The term ‘conscience’ relates to ethics and ethical behaviour. A company secretary should be in a position to remind the board about ethical considerations when formulating policy or making decisions. Although the board may appoint a director to have overall responsibility for corporate social responsibility, the company secretary may provide support for this director. The company secretary should also have a good understanding of company law and corporate governance requirements and should be able to advise the board on related issues.

An important aspect of acting as conscience of the company for a listed company is to ensure that the company complies with the provisions of the UK Code, or is aware of any non-compliance and is prepared to explain such non-compliance to shareholders. The company secretary may therefore be required to give advice to board meetings on governance issues. Alternatively, the company secretary may advise the board chairman when a governance issue should be discussed at a board meeting, so that it is put on the agenda for the meeting.

The company secretary may have a similar role with regard to the company’s code of ethics, if it has one. The board may require advice from time to time about implementation of the ethics code, or action that the board should take in support of the code. Alleged breaches of an ethics code may be investigated by the company secretary, at the request of the board.

The role as conscience of the company may also extend to social and environmental policy and monitoring compliance with policy or progress towards achieving policy objectives. If the company produces an annual CSR report, the company secretary may be given the responsibility for compiling the report.

Examiner’s comments

The key to answering this question was to understand the meaning of ‘conscience’. A number of answers simply provided a list of responsibilities of a company secretary. Others stated that acting as a ‘conscience’ meant providing the board with timely information, or focussing on CSR.

(b) Discuss the meaning of corporate citizenship, why it might be important for a company to be regarded as a good ‘corporate citizen’ and indicate the difficulties for an international mining company to present itself as a good corporate citizen to the public.

Suggested answer

Corporate citizenship refers to a company acting as a citizen of the country or community in which it exists and operates. In using this term, it is assumed that a citizen has certain duties and responsibilities to the state, such as acting within the law, paying taxes, treating other citizens with consideration and respect, and contributing to the general welfare of the community.
It may be argued that the prime objective of a company is to maximise the wealth or well-being of its shareholders. If a company acts as a corporate citizen, it would also be expected to show concern for the interests of other stakeholders and to adopt a stakeholder approach or enlightened stakeholder approach to corporate governance and sustainability policies.

It is sometimes suggested that a company, particularly a listed company, should be a good corporate citizen. There are several reasons for this, linked to the importance of reputation for the particular company. Acting as a good corporate citizen may have the effect of creating trust between the company and various influential stakeholder groups. In the case of Kwill, a mining company, a good corporate reputation may help to win support from institutional investors, especially those with a formal Socially Responsible Investment policy. Institutional investors may be more prepared to hold shares in the company as a long-term investment, and may be more willing to subscribe for new shares or bonds if the company tries to raise fresh capital.

A good reputation may also be significant for the company’s dealings with the government, and the government may be more willing to consider the company’s concerns when matters such as new health and safety legislation is under consideration, or when the company is seeking government permission to open up a new mine in the country.

For some listed companies, a reputation with the general public as a good social citizen may also be of value, in persuading individuals to support the company, for example, by purchasing its goods or services. This is not such a significant issue for a mining company such as Kwill; however, a good reputation may help to persuade talented individuals to apply for jobs with the company, and to remain with the company once employed. Employment policies that show concern for employees may help to reduce risks of industrial disputes.

However, for an international mining company, there are significant obstacles to being considered a social citizen and to acting as a social citizen. A mining company may have policies for restoring an environment to a natural state after a mine ceases to operate and has been closed down, but until this happens the company (because of the nature of its operations) will damage the environment. Working conditions in many mines are poor, and even if the company pays good wages to its miners and tries to implement effective safety measures, it is difficult for a mining company to implement positive social policies.

A multinational company may find it difficult to act as a corporate citizen because of the number of different countries and communities in which it operates. It may be difficult to act as a citizen of a large number of different countries. By its nature, a global group of companies is not associated with any particular country and its employees may also fail to identify with the communities in which the group operates.

The tax arrangements of a multinational are often organised towards minimising the tax liabilities of the international group, and this too may be inconsistent with the concept of corporate citizenship.

**Examiner’s comments**

Most candidates answering this question accurately explained the meaning of corporate citizenship. The weakest answers in general were those that dealt very quickly with the meaning of corporate citizenship and the possible importance of being regarded as a good corporate citizen, and devoted much of the answer to writing about the working environment in the mining industry.

Some answers ended with a number of recommendations about what the company should do to become a better corporate citizen. This was not a requirement of the question, so these suggestions were not relevant and did not earn marks.
(c) Explain how the CSR policies of a public company in the mining industry are likely to differ from those of a major charity.

Suggested answer

A mining company is a commercial organisation whose primary objective is financial. This may be to increase the wealth of its shareholders. Any social and environmental policy will be subordinate to this overall financial goal. In contrast, the main objective of a charity is typically a social or environmental objective. The financial objective of a charity, which may be to raise funds for charitable spending but to keep spending within available funding, is subordinate to the social or environmental objective.

A charity may have one social or environmental objective which is paramount to all other objectives. For example, the objective of a medical research charity may be to find ways of treating or curing a medical condition, and all other objectives are relatively insignificant. For a commercial company, the general public, and socially responsible investment institutions, may expect a company to pursue a number of different social and environmental objectives, without necessarily giving priority to any of them.

Mining is associated with damage to the environment and difficult working conditions. Social and environmental policies of a mining company may be developed in order to promote the reputation of the company, and make investors willing to invest in its shares. In contrast, a charitable organisation should not need to develop policies to enhance its reputation with the public, although the public will expect a charity to use its funds effectively and without unnecessary waste.

Examiner’s comments

This appeared a difficult question to answer very well for many, especially as Question 6 was the final answer attempted by many candidates and time may well have been running short during the exam.

The scenarios included here are entirely fictional. Any resemblance of the information in the scenarios to real persons or organisations, actual or perceived, is purely coincidental.