Part One – Chartered Governance Qualifying Programme

Corporate Governance

Mock Examination Marking Scheme

November 2023

<u>Notes From Neill</u>

The marking scheme provides a good indication of the kind of answers for which marks are awarded. It does not cover all possible answers. Marks are awarded by the examiner for answers that may fall outside the marking scheme but demonstrate a good knowledge of the syllabus area and is relevant to the question and scenario.

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Section A

Answer ALL questions in this section

1. *Explain the four different theoretical approaches to Corporate Governance relating to the shareholder and stakeholder and provide examples for each. (5 marks)*

The Shareholder Value Approach provides that the board of directors should govern their company in the best interest of its owners (1). It was historically adopted in listed companies where there was a separation of ownership and control. (1)

The stakeholder Approach provides that the board should have regard to the views of all stakeholders and in taking decisions they should balance the interests of all stakeholders. (1) Examples of countries adopting the stakeholder approach are France and Germany. (1)

The Inclusive Stakeholder Approach provides that theboard should consider the legitimate interests and expectations of all key stakeholders on the basis that this is in the best interests of the company, with the shareholder does not have any predetermined precedence over other stakeholders. (1) An example of a country adopting the Inclusive Stakeholder Approach is South Africa. (1)

The Enlightened Shareholder Approach provides that in considering actions to maximise shareholder value, the board should look to the long term as well as the short term and consider the views of and impact on other stakeholders in the company. The views of other stakeholders are, however, only considered in so far as it would be in the interests of shareholders to do so. (1) The enlightened shareholder value approach was introduced in the UK by the Companies Act 2006 (CA2006), which imposed a statutory duty on directors to ‘promote the success of the company for the benefit of its members as a whole (1)

2. *Explain why the reporting lines of a Company Secretary are important and how those reporting lines should be managed if the Company Secretary is also the company's in-house legal adviser. (5 marks)*

The reporting lines of a Company Secretary are important because of the need to maintain the independence and integrity of the role.(1) This is emphasised in the CGI guidance note on "Appointment of the company secretary". (1)

In particular, in relation to their governance and statutory role, the Company Secretary should report to the Chair of the Board of directors.(1) This is recommended in the CGI best practice guidance note "The duties and reporting lines of the company secretary."(1)

The Company Secretary's role as an independent advisor to the Board, could be compromised if they report to an executive director or senior manager in relation to their role as Company Secretary. (1)

If the Company Secretary is also acting as the company's in-house legal adviser, then they can report to an executive director or senior manager in relation to that role. (1)

But in order not to compromise their role as Company Secretary, they should still have a separate reporting line to the Chair of the Board in relation to their role and duties as Company Secretary. (1)

3. *Explain the matters that the board should consider when introducing a whistleblowing procedure. (5 marks)*

The board should ensure that the purpose, scope and coverage of the whistleblowing policy is established. (1) Examples of what matters the procedure covers include illegal activity and bullying. (1)

The Company Secretary can play a key role in developing and implementing the procedures. (1)

For the policy to be successful, a culture of trust and openness should be built with the example being set by the board. (1) A statement should be made that the organisation takes malpractice or misconduct seriously and is committed to a culture of openness in which employees can report legitimate concerns without fear of penalty or punishment. (1)

It is important that the workforce know the procedures for reporting a matter as well as how investigations are conducted an followed up. (1)

Processes should be implemented to ensure anonymity and protection of the whistleblower, whilst ensuring ongoing communication. (1) This could include the use of a third party to receive calls or emails. (1)

The policy and procedures should be widely circulated throughout the company and become part of induction and training (1)

Following the implementation of the whistleblowing procedure, regular reports should be made to the board (1) and the procedure should be continually monitored (1)

4. *Explain the potential threats to auditor independence and provide examples of how these may arise. (5 marks)*

The International Federation of Accountants (IFAC) identifies a number of potential threats that its members are required to watch out for when conducting audits. (1)

A self-interest threat is when the judgement of the auditor is affected by a desire to protect their fees. (1) An example of this is when the audit firm is earning such a large amount of fee income that it could cause problems to the auditor firm if it loses the business. This was the case for Enron in the US. (1)

A self-review threat arises when the audit firm is placed in a position where it is checking its own work. (1) An example of this is when an audit firm undertakes non-audit work for the company, such as providing book keeping services and the annual audit involves checking the work done by the firm's own employees. (1)

An advocacy threat arises when the audit firm is asked to give its formal support to the company by providing public statements. (1) An example of this could be in supporting the company in an investment raise or in a legal case. (1)

A familiarity threat occurs when an auditor becomes too familiar with the company. An example of this is when the audit partner or the audit firm has a working association with the company for too long. (1)

5. *Describe why a directors' remuneration policy must be approved by the shareholders of a UK incorporated quoted company, and explain the circumstances the company would need to put its directors' remuneration policy to shareholders for approval at its next Annual General Meeting. (5 marks)*

The Companies Act 2006 provides that a quoted company cannot make any payments to its directors unless the payments are made in accordance with a directors' remuneration policy (1) which has been approved by the company's shareholders (or the payment has been separately approved by shareholders). (1)

The three circumstances in which the company would need to put its directors' remuneration policy to shareholders for approval at its next Annual General Meeting are:

- If it has been three years since the policy was last approved by shareholders. (1)
- If the company wishes to revise the policy. (1)
- If the directors' remuneration report was not approved by an advisory vote of shareholders at the previous Annual General Meeting. (1)

This was a really tough question that was asked by the examiner in June 2021. I am not sure that even I would get full marks on this! I added it to demonstrate the curved balls that may be thrown at you.

Section B

*Answer **THREE** questions only*

6. Cratchit Limited (Cratchit) is a large IT retailer with over 2500 employees. It has a Board of five directors. Three directors are executive, including Bob Bumble, the CEO, and the Finance Director. The other two directors are non-executive: Nancy Sowerby, the Chair of the Board, and Tom Chitling.

   Bob has informed Nancy that he has received a proposal from Marley Limited (Marley) for them to supply Cratchit a range of reconditioned laptop computers, which Bob thinks will be on good terms for Cratchit. It will be the first time that Cratchit has contracted with Marley. Bob wants the supply agreement to be discussed at the next Board meeting of Cratchit. He has mentioned to Nancy that Tom is also one of the non-executive directors of Marley.

   Nancy has recently sought help from Rose Maylie FCG, a governance consultant. Nancy knows that due to the size of the company, that Cratchit should seek to implement the Wates Corporate Governance Principles for Large Private Companies (Wates Principles) and is interested in understanding how a company secretary may help. She is interested in appointing a company secretary on a full time basis, but in speaking to Bob, he thinks that a more effective approach would be to utilise outsourced resources.

   As Rose Maylie, undertake the following:

   (a) Provide a summary of the steps that should be taken and issues that should be considered by the Board of Cratchit, as a result of the fact that Tom is on the Board of Marley. (10 marks)

   (b) With reference to the four main categories of roles they could perform, explain how a Company Secretary could assist the Board of Cratchit. Also, explain the advantages and drawbacks in appointing a Company Secretary as full time member of staff rather than outsourcing the role. (15 marks)

Total for Question 6: 25 marks

(a) *Provide a summary of the steps that should be taken and issues that should be considered by the Board of Cratchit, as a result of the fact that Tom is on the Board of Marley. (10 marks)*

Answer should show an understanding of the concept of conflicts even if the full Companies Act provisions are not described in detail.

Conflict of interest under section 175 Companies Act

The fact that Tom is a director of Marley as well as a director of Cratchit means that a conflict of interest has arisen for him. (1)

The first point for the Board to consider is the duty of directors under section 175 of the Companies Act 2006 (CA 2006). This states that directors must avoid a situation in which they have, or may have, a direct or indirect interest that conflicts, or may conflict, with the interests of the company. (1)

For the purposes of section 175, a conflict of interest includes a conflict of duties (section 175(7)). (1)

In this case, Tom has a conflict of duties, because he has a duty to the Board of Cratchit and a duty to the Board of Marley. These duties will conflict when the two companies are considering entering into a contract with each other – both in relation to the negotiation and entry into the contract, and then during the period of performance of the contract. (1)

In order to prevent Tom from breaching his duty under section 175, the Board of Cratchit needs to approve his conflict of interest, that is, give him permission to remain a Board member of Marley and Cratchit during the period in which the contract is negotiated and, if it is entered into, during the period in which it is in operation. (1) As Cratchit is a private limited company, the Board is permitted to approve a conflict under section 175 provided that the articles of association of Cratchit do not prevent them from doing so. (1) When the Board is voting to approve the conflict, Tom cannot vote or be counted in the quorum. (1)

Disclosure of interest under section 177 CA 2006

Section 177 of the CA 2006 requires a director of a company who is interested in a proposed transaction with the company to declare his interest to the other directors. (1) Under section 177, the declaration can be made at a meeting of the directors or by notice to all of the directors. (1)

As a director in both Cratchit and Marley, Tom has a conflict of duties requiring him to declare the interest. The Board of Cratchit should therefore ensure that Tom formally declares his interest in the proposed Marley contract when it is being considered by the Board, either by formally giving notice of his interest to all of the Board prior to the Board meeting or by formally declaring it at the start of the Board meeting at which the contract is first considered. (1)

Voting on the contract with Marley

The Board will need to check the provisions on Board voting in the articles of association of Cratchit which will determine whether Tom is permitted to vote on a resolution of the Board to approve the contract with Marley despite being interested in the contract. (1)

However, even if the articles permit Tom to vote on the contract despite his interest in the contract, it would be advisable, for the Board of Cratchit, to exclude Tom from participating in the Board discussion about the contract and to ask him not to vote in relation to the contract. (1) This is because it would be better practice to exclude him from the voting and there are a sufficient number of other directors on the Board to form a quorum and vote on the contract because none of the other directors are conflicted. (1)

Also, under s173 Tom has a duty to exercise independent judgment, which it is unlikely he could meet (1)

(b) With reference to the four main categories of roles they could perform, explain how a Company Secretary could assist the Board of Cratchit. Also, explain the advantages and drawbacks in appointing a Company Secretary as full time member of staff rather than outsourcing the role. (15 marks)

Governance

A Company Secretary has a key role to play in the governance of the company. This refers to their role in ensuring that the Board (and any committees) are constituted properly and that its processes and decision making are operated effectively and in accordance with good governance practice. (1)

Statutory and regulatory compliance

It is unclear whether the company has anybody with legal or governance qualification assisting to ensure that Cratchit complies with the Wates principles. (1)

A Company Secretary will also have a role to play in ensuring that the company complies with law and regulation. In particular, the requirements of the Companies Act 2006, such as filing information at Companies House and compliance with director duties (1)

Communication

A Company Secretary has a central role in facilitating information flows at Board level. A Company Secretary is a primary point of contact between Board members and between the Board and management. (1)

Advising the Board and senior management

A Company Secretary has an important role in advising the Board and management of the company on a range of issues including:

- Board induction, training and evaluation (1)
- Risk management and internal control procedures (1)
- Relationships with stakeholders such as suppliers and customers (1)
- Corporate social responsibility (1)
- Business ethics (1)

The advantages of an inhouse Company Secretary is:

- An in-house company secretary acquires an in-depth knowledge and understanding of the company and its history and also develops relationships with the board and management that an external firm lacks. (1)
- An in-house company secretary is available at all times. (1)
- A qualified in-house company secretary offers a wide range of services and is able to take on other responsibilities (1).

- An in-house company secretary may provide support that is difficult for an external firm to provide; for example, assisting the chairman to prepare for meetings. (1)
- An in-house company secretary can truly act as the ‘conscience of the company’ and has no conflict, in that they do not do other work for the company such as providing legal or accountancy services. (1)

The drawbacks of an inhouse company secretary is:

- It could be more expensive. (1)
- As part of an outsourced firm Cratchit may be able to draw upon a wider range of services and expertise from the firm. (1)

7. Fezziwig plc (Fezziwig) is a marketing agency with its shares listed on the London Stock Exchange. The Fezziwig Board comprises three executive directors and four non-executive directors, including a Senior Independent director (SID). The Board has decided that it needs to take steps to improve its stakeholder engagement. Fezziwig has a large workforce, who are mainly based at its head office. However, since the pandemic, around a quarter of its workforce continue to work from home. The board recently received a petition signed by many of those employees working from home expressing how isolated from the business they feel and requesting a meeting with the board. Also, over the last year Fezziwig has lost a number of its largest customers. Dora Spenlow, the CEO has suggested to the board that the reason for these customer losses could be that their competitors are offering cheaper services.

Fezziwig has a number of institutional shareholders who are unhappy because its share price halved in the week following an announcement of poor results. One of the institutional shareholders has voiced their belief that the reason for the drop in the share price and the poor financial results is as a result of losing a number of their largest customers. The shareholder blames Dora Spenlow, the CEO, for this. The institutional shareholders are also concerned of a rumour that Dora may have sold some shares in the company ahead of the announcement of the financial results.

As the Company Secretary of Fezziwig Plc, you have been asked to undertake the following:

(a) Prepare a briefing note for the Board of Fezziwig discussing how it can improve its engagement with both its workforce and customers. (12 marks)

(b) Analyse the steps that the institutional shareholders should take, and the rights that they could exercise, in light of their concerns about the performance of the CEO and also her potential sale of shares. (13 marks)

Total for Question 7: 25 marks

(a) *Prepare a briefing note for the Board of Fezziwig discussing how it can improve its engagement with both its workforce and customers. (12 marks)*

Briefing note format (1)

Provisions in the Code regarding stakeholder engagement

Fezziwig has a responsibility to engage with its key stakeholders. In doing so, it can adopt either an interactive approach or a proactive engage with its key stakeholders, rather than just being reactive in response to issues which are raised. (1) At present it seems that the company is reactive to stakeholder needs, following the petition received from the workforce (1) and also the fact that the CEO does not really know why some of their largest customers have left (1)

The company should therefore be proactive in its engagement with stakeholders. This will also enable the Board to comply with its duty to promote the success of the company under section 172 of the Companies Act. (1)

Under Principle D of the Code, the Board is required to ensure effective engagement with, and encourage participation from, its shareholders and other stakeholders. Provision 5 of the Code then goes on to include specific requirements about the methods of workforce engagement. It states that for engagement with the workforce, one or a combination of the following methods should be used:

- a director appointed from the workforce
- a formal workforce advisory panel
- a designated non-executive director

There are two groups within the workforce – those working in the office and those working from home. Therefore it will be important to consider these different groups when selecting which, if any, of the three possible methods of workforce engagement set out in the Code are appropriate to its business and workforce, or whether to adopt an alternative method (1).

Regarding the appointment of a director from the workforce, Given that there are two distinct groups, it may be difficult for the director to represent all the workforce as each group will have different needs and interests. (1)

Fezziwig could consider a workforce advisory panel, ensuring that there was a good balance of members from the two groups within the workforce (1). The company secretary could facilitate these meetings. (1)

Fezziwig has four non-executive directors and so could designate one of those directors as the director who will take the lead in overseeing workforce engagement. (1) The company secretary could support the NED in arranging their engagement with the workforce (1)

Fezziwig could also consider using more than one of the three methods set out in the Code for workforce engagement. For example, it could use an both an Advisory Panel and designate one of its non-executive directors as responsible for workforce engagement. (1)

Alternatively, Fezziwig could use the option given in the Code of choosing another method of engagement and not using one of the three methods listed in the Code, (1) The company will only be compliant if it explains why the alternative arrangements are effective. (1) Examples of methods could include holding monthly ‘townhall’ meetings where all staff attend and are able to provide feedback on issues. Also, a greater use of staff surveys or staff focus groups. (1)

(a) *Analyse the steps that the institutional shareholders should take, and the rights that they could exercise, in light of their concerns about the performance of the CEO and also her potential sale of shares. (13 marks)*

Institutional Shareholders who have concerns about a company in which they invest have a responsibility to engage with the company about their concerns. (1) Those who are signatories to the Stewardship Code should follow the Principles set out in the Code in relation to engagement with the Boards of the companies in which they invest. The basic Principle is that the investors should engage with issuers to protect the value of their assets (Principle 9). (1)

Steps Shareholders can take

In the case of Fezziwig, the change that the investors may be seeking is a change of Chief Executive (1) In order to engage with the Board of Fezziwig, the investors should approach the Chair of Fezziwig to ask for a meeting. The Chair, rather than the Chief Executive, is the key point of contact for investor engagement and so it is the Chair that the investors should seek to engage with. (1) The UK Corporate Governance Code (Provision 3) states that the Chair should seek regular engagement with major shareholders in order to understand their views on governance and performance against strategy and should ensure that the Board as a whole has a clear understanding of the views of shareholders. The Governance Code also provides that the Senior Independent Director (SID) should have a role as an intermediary for the other directors and shareholders (Provision 12). In this case, given that the criticism relates to the fundamental issues of strategy and the Chief Executive, it may be appropriate for the shareholders to ask for the SID to be included in their dialogue (1)

Exercise of shareholder rights

If the shareholders do not think that engagement with the boards working then they should escalate stewardship activities to influence issuers (Principle 1)(1).

Whilst we know that one shareholder has expressed their concern relating to the Chief Executive, we are not aware that others think the same. Principle 10 states that Investors should where necessary participate in collaborative engagement to influence issuers. In this respect, the shareholder should contact other shareholders to establish whether they share the same concerns regarding the Chief Executive (1)

The rights that the shareholders could use in light of their unhappiness with the Chief Executive include:

If the Institutional shareholders collectively hold more that 5% of the votes, they can submit a requisition calling for a shareholder meeting to put forward resolutions, for example a resolution seeking to remove the CEO as a director. (1)

If the AGM is to be held shortly, they may vote against one or more resolutions, in particular against the resolution for the re-election of the Chief Executive or approval of the remuneration report (1)

Again, if the AGM is to be held shortly and they collectively hold more that 5% of the votes, they may submit a requisition for a shareholder resolution to Fezziwig to be proposed at

AGM. This could include a resolution to seek to appoint one or more nominee directors to the Fezziwig Board. (1)
The above actions may not lead to the resolution being passed or failing, as the institutional shareholders seek, but they would provide a strong indication to the board of the shareholders views. (1)

The potential sale of shares by the CEO

Under s. 123 of the Financial Services and Markets Act 2000 (FSMA) engaging in insider dealing is a civil offence. (1) Part V of the Criminal Justice Act 1993 makes dealing in shares on the basis of insider dealing a criminal offence (1) The definition of Insider Information is information relating to the shares of a particular company, which is specific or precise and would be likely, if made public, to have a significant effect on the price of the shares (1) Also, Persons Discharging Managerial Responsibilities (PDMR), of which Nancy is one, is prohibited from conducting any transactions in the company's securities during a closed period of 30 calendar days before the announcement of the year-end results or any interim financial report. (1)

The scenario does not provide any facts relating to the sale of shares by Nancy and it appears it is only a rumour. However, the shareholders should bring this matter to the attention of the Chair for investigation. This investigation could be undertaken by the Company Secretary, who is likely to have advised Nancy on the rules relating to Directors' sale of shares. (1)

The investigation is likely to focus on the timing of the sale of shares. If these were in the period of 30 days ahead of the announcement, then unless there was an exceptional circumstance, then Nancy was not allowed to deal in the shares. (1) An exceptional circumstance could be to meet the terms of a court order (1)

Irrespective of the timing of the sale of the shares, if the sale of the shares in addition to any other share transaction reached a value above EUR 5,000 in the calendar year, Nancy will have been required to notify the company and the FCA, no later than three working days after the date of the transaction. (1) On receipt of such a notification, the company is required to make an announcement to the market no later than two working days after they have been informed of the transaction (1)

If Nancy has breached the FSMA2000, she should be removed from office and will likely be subject to a penalty from the FCA. She may also be subject to criminal charges. (1)

8. Copperfield Plc (Copperfield) is FTSE250 company with its shares listed on the London Stock Exchange. Historically, the company's publications have been largely paper based but in recent years it has moved to electronic publishing. However, the board believes that this transformation is not happening quick enough. The Board of Copperfield consists of the three executive director, Tim Cratchit, Peter Trotwood and Fred Monks. For the last twelve years, the Chair of the board has been Bill Micawber, who was formerly the CEO of another publishing company. The board has three independent Non Executive Directors, Charles Mann, Alan Fagin and Toby Crackit. Charles is an accountant and the other two have a backgrounds in publishing. Charles and Alan have been members of the board for 8 years and Toby has been a member of the board for two years. All the members of the board are male and white.

   Copperfield recently conducted a staff survey, allowing staff to give anonymous feedback. An outcome of the survey is a suggestion that the behaviours of some of the sales team are not in line with the company's Code of Ethics, There is also some feedback from customers that they feel that they have been unfairly treated regarding the price that they have been charged for publications. Upon contacting the customer care line, they found the staff to be rude and unhelpful.

   As the Company Secretary, you have been asked by Bill to undertake the following:

   (a) Provide a briefing note, setting out the key issues that the nomination committee will need to consider in creating a succession plan for the Board of Copperfield and how it will implement these. (13 marks)

   (b) Analyse what steps the Board could take to ensure that the culture of the company is aligned with the company's values and its Code of Ethics. (12 marks)

Total for Question 8: 25 marks

(a) *Provide a briefing note, setting out the key issues that the nomination committee will need to consider in creating a succession plan for the Board of Copperfield and how it will implement these. (13 marks)*

Briefing Note format (1)

The key aims of succession planning are to ensure that Copperfield has 'balanced board' Board with the right skillsets, breadth of perspectives and diversity. (1)

Unless the company's articles of association specify a minimum or maximum number of directors, the size is left to the board and will be dependent on the size of the company, the complexity of the business and the industry or sector in which it operates. (1)

Key Issues

Copperfield may not be compliant with the UK CG Code in that Bill Monks does not fulfil the criteria under Provision 10 of the UK CG Code, which states that a director is not deemed to be independent after serving for 9 years. As a provision of the code this should be adhered to on a 'Comply or Explain' basis. Copperfield should consider a new Chair unless it has a good explanation to retain Bill. (1)

Charles and Alan have been on the board for 8 years and as per provision 10 of the UKCG code, replacements will need to be appointed within a year. (1)

Charles is the only member of the board that we know has financial experience, so it will be important to consider this in his replacement. (1)

The diversity of the current board is poor with all members of the board male and white. (1)

No mention is made of a SID but having one can play an important role in the company, supporting the Chair. (1)

Implementation

The Code (Principle J) states that an effective succession plan should be maintained for the Board. Appointments and succession plans should be based on merit and objective criteria and should promote diversity, including diversity of gender, ethnic backgrounds and personal strengths.

The nomination committee has the responsibility for ensuring that plans are in place for orderly succession to the Board (Provision 17 of the Code).

Succession planning for the Board should be in place for the short, medium and longer term:

– Short-term contingency planning – New Chair (1)
– medium term planning to replace the other two non-executives over the next year. (1)

– long-term planning to ensure that in future years the members of the Board have the right skills and attributes, with the right balance in numbers between executive and nonexecutive directors, to operate effectively and to implement the company's strategy and expansion plans. (1)_

Principle K of the UK Code requires the Board and its committees to have a combination of skills, experience and knowledge. The FRC Guidance on Board Effectiveness suggests that skills matrices, mapping the existing skill set of the Board against that required to execute strategy and meet future challenges, can be an effective way of identifying skills gaps. We know that Copperfield is seeking to accelerate its diversity into electronic publishing. Skills and experience should be sought in this area. (1)

The UK Code requires the Audit committee to have a board member with financial expertise. This is currently Charles who is likely to leave the board. (1)

In making a new appointment, the nominations committee should consider its current board composition of white men only and should take into account the FRC Guidance on board Effectiveness, which states that 'Diversity in the boardroom can have a positive effect on the quality of decision-making by reducing the risk of 'group think'. (1) As a FTSE250 company, the nominations committee should also consider the Women on boards Report and the Parker Review and consider appointing women and those with different ethnic backgrounds. (1)

The board should consider appointing Toby as a SID. This will help Copperfield to comply with the UKCG but also will help to support the new Chair upon their appointment. (1)

(b) Analyse what steps the Board could take to ensure that the culture of the company is aligned with the company's values and its Code of Ethics. (12 marks)

A company's culture means its values, attitudes and behaviours and the way it conducts its business. (1)

Principle B of the UKCG code states that the board should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned. All directors must act with integrity, lead by example and promote the desired culture.

The board needs to adhere to s172 and should understand the views of the company's other key stakeholders and describe in the annual report how their interests are being taken into account. The scenario provides that the company is seeking and receiving feedback, but it will be important that Copperfield acts on the feedback (1)

Steps that Copperfield can take

The Board needs to agree what the company's values are, and then consider how Copperfield's purpose and strategy are aligned with those values. (1)

Copperfield recently conducted a staff survey, with the outcome that the behaviours of some of the sales team are not in line with the company's Code of Ethics, There is also some feedback from customers that they feel that they have been unfairly treated regarding the price that they have been charged for publications and that the customer care staff were rude and unhelpful. (1)

A key problem is that staff may not be aware of the code of Ethics and the expected behaviours. The Board ensure that the Code of Ethics is publicised internally and forms part of staff induction and training. (1) The Code could also be publicised on the company's website and in its communications with the company's customers and suppliers, so that it is clear what the company's values are. (1) Training should be provided to existing staff (1) Staff should be aware of actions. Taken for those that do not conform to the Code of Ethics (1)

It is also important that the board adheres to the agreed Code of Ethics and lead by example, setting the "tone from the top." (1)

The Board needs to ensure that Copperfield's employee performance management and reward systems encourage behaviours that are consistent with the company's culture and values. (1)

There needs to be a culture of openness and accountability, so that employees feel able to raise concerns about behaviour. It is good that the staff survey allowed anonymous feedback. A formal a whistleblowing policy and procedures to allow staff to raise formal complaints anonymously. (1)

Culture and values should be a standing items for the Board meetings.(1) and the Board should get first-hand experience or indications of the culture within the company by being able to have direct interaction with employees and other stakeholders. (1)

9. Pegotty Limited (Pegotty) is a construction company listed on the London Stock Exchange. The Pegotty Board consists of five directors: a Chair, two non-executive directors, a Chief Executive and a Finance Director.

   The Audit Committee has been reviewing Pegotty's draft annual report and accounts (draft accounts) for the previous financial year and two of the committee members have raised a concern about whether the treatment of income in the draft accounts complies with accounting standards. The Chair of the Audit Committee, James Steerforth, has passed this concern on to Betsy Trotwood, the Finance Director. Betsy has told James that she is happy with the treatment of income in the draft accounts, and that the auditors have not flagged it as a concern, so there is nothing for the committee to be worried about. Betsy does not think that the concern needs to be mentioned at the next Board meeting when the draft accounts are to be discussed.

   As part of the external audit, the auditor has raised two areas of concern with the Board. These concerns were firstly whether there was sufficient control over large purchase orders made for building materials and secondly whether the company was sufficiently prepared to respond to a cyber-security attack. As a result of the concerns raised by the external auditor, the Betsy Trotwood, the Finance Director of Pegotty wants to improve the company's internal controls. The company does not currently have an in-house internal audit function and instead it outsources the internal audit function by using an external professional firm to provide advice on internal control issues. Betsy is considering whether Pegotty should establish an in-house internal audit function to replace the externally provided function.

   As the Company Secretary of Pegotty, you have been asked to undertake the following:

   (a) Analyse the steps that the Audit Committee should take in light of the concern raised by the committee members about the treatment of income in the draft accounts. Include what disclosures should be made in the Audit Committee report, which forms part of Pegotty's annual report and accounts. Explain what responsibility the Board as a whole has in relation to approving the annual report and accounts. (12 marks)

   (b) Analyse what elements of Pegotty's internal control systems should be reviewed in order to address the concerns raised by the external auditors, and what role an internal audit function could play in improving internal controls and risk management. Include the advantages and disadvantages of using an in-house internal audit function. (13 marks)

Total for Question 9: 25 marks

(a) *Analyse the steps that the Audit Committee should take in light of the concern raised by the committee members about the treatment of income in the draft accounts. Include what disclosures should be made in the Audit Committee report, which forms part of Pegotty's annual report and accounts. Explain what responsibility the Board as a whole has in relation to approving the annual report and accounts. (12 marks)*

Role of the audit committee in relation to the accounts

The audit committee has a key role to play in relation to the annual report and accounts and the audit of those accounts. The Code states (Provision 25) that the responsibilities of the audit committee include monitoring the integrity of the financial statements of the company and monitoring the effectiveness of the external audit process. The committee is also required by the Code to report to the Board on how it has discharged its responsibilities. (1)

Further information from the finance director

Although it is the responsibility of management to prepare the draft accounts in accordance with accounting standards, the audit committee's role is to consider whether management has adequately done so and to raise any matters of concern, taking into account the overall requirement that the accounts should be fair, balanced and understandable. (1)

The audit committee cannot therefore simply accept the finance director's assurance about the matter of concern that has been raised about the treatment of income. The audit committee Chair should ask the finance director to provide further written information and reassurance to the committee about the treatment of income in response to the concerns that have been raised. (1)

Raising the issue with the auditors

It is also essential for the audit committee to raise the matter of concern in relation to the treatment of income directly with Pegotty's auditors and ask the auditors to report to the committee, which could include the auditor being invited to attend part of the committee meeting (with the finance director not in attendance) to explain their view about the matter of concern in relation to the treatment of income. (1)

Raising the issue at the next Board meeting

The audit committee should report to the Board on any significant financial reporting issues and judgements made in connection with the preparation of the company's financial statements and how these were addressed (this is set out in the FRC's guidance for audit committees which accompanies the Code). (1)

In this case, it is essential that the Chair of the audit committee includes in the committee's report to the next Board meeting information about the committee's concerns regarding the treatment of income. The audit committee should present the concerns raised to the Board and explain whether, in light of their further discussions with the finance director and with the auditors, those concerns have now been addressed. (1)

The audit committee should also consider, in light of the further discussions it has had with the finance director and the auditors, whether the issue of concern also raises concerns about the effectiveness of the external audit process which needs to be reported to the Board. (1) For example, if the committee is not satisfied that the auditors had considered the point about the treatment of income properly and that they should have done, this is a matter that they may wish to raise with the Board, and also raise with the auditors as a matter on which their audit work needs to improve. (1)

Disclosure about the issue in the next audit committee report

The annual report is required by the Code (Provision 26) to include a report from the audit committee. That report must describe any significant issues that the audit committee considered relating to the financial statements and how these issues were addressed and an explanation of how it has assessed the independence and effectiveness of the external audit process. (1)

Therefore, even if the audit committee is satisfied with the treatment of income in the accounts following its further discussions with the finance director and with Pegotty's auditors, the audit committee Chair should ensure that there is a disclosure about the issue, and how it has been settled, in the audit committee report in the annual report. (1)

Responsibility of the Board for the annual report and accounts

The whole Board is responsible for the annual report and accounts and, even though the other directors are relying on the audit committee to bring any matters of concern to their attention, each director has equal responsibility. (1) Under the Companies Act 2006, it is the responsibility of all of the directors to only sign off on the annual report and accounts if they are satisfied that they show a true and fair view of the assets, liabilities and financial position of the company. (1)

(b) *Analyse what elements of Pegotty's internal control systems should be reviewed in order to address the concerns raised by the external auditors, and what role an internal audit function could play in improving internal controls and risk management. Include the advantages and disadvantages of using an in-house internal audit function. (13 marks)*

A company's internal control system means the structures, policies and procedures that it has in place to manage its business risks, that is its financial, operational and compliance risks. (1)

The internal controls that should be used to manage business risks can be divided into three types:

- Preventative controls – to prevent an adverse risk from happening.
- Detective controls – for detecting risk events when they occur.
- Corrective controls – for dealing with risk events that occur and their consequences. (1)

The internal controls can also be categorised by reference to the type of risk that they are designed to manage, that is financial controls, operational controls and compliance controls. (1)

In order to be effective, the internal controls need to be well designed, so that they can achieve their purpose, and they must be applied properly in practice. (1)

Concerns raised by the auditor

In the case of Pegotty, the auditor has identified a financial risk relating to large purchase orders, which it is concerned is not being managed properly.

Pegotty needs to improve its internal controls to ensure that sufficient control measures are in place in relation to purchase orders. This would include reviewing the authorisation process and authorisation levels to ensure that they are appropriate and adequate, reviewing how the controls are implemented and monitored (including for example how approvals are recorded) and checking that the controls are being adhered to in practice. (1)

The auditor has also identified an operational risk, relating to the response measures that Pegotty has in place if there is a cyber-attack affecting the company's IT systems. This is a corrective control matter. (1) Pegotty needs to have a disaster recovery plan in place to manage and mitigate the impact of a cyber-attack, it should review its cyber-security policies and procedures and it should ensure that the relevant staff have up-to-date knowledge and training on how to respond to a cyber-attack. (1)

Role of internal audit

The key purpose of an internal audit function is to evaluate and improve the effectiveness of a company's internal controls and risk management system. (1)

An internal audit team should help the Board to identify whether the appropriate internal controls and risk management steps are in place. (1)

The internal audit team also focuses on particular areas of concern in relation to risk and so should be the team that Pegotty uses to review the control issues raised by the auditors. (1)

Using an in-house internal audit team

By using an in-house internal audit team, Pegotty would be using a team of its own employees to perform the function, rather than outsourcing the function to an external professional firm.

The benefits of an in-house internal audit team are that the team would understand the organisation, its culture, operations and risk profile. (1) It can be properly integrated into the business and be an ongoing part of the checks and balances which are a key part of the internal controls. (1) It can become the 'eyes and ears' of the Board in relation to risk management and internal controls. (1)

The disadvantage of using an in-house internal audit team would be the potential loss of the external resources, experience and skills made available by using an external professional organisation. (1) Use of an in-house team can also sometimes be less cost effective for a smaller company, in contrast to buying in the service on an ad hoc basis from an external firm. (1) Pegotty would need to weigh up the cost of creating an in-house internal audit team against the benefits of the ongoing focus on internal controls and risk management, and the creation of internal knowledge and skills, that such a team would bring, particularly given the concerns raised by the external auditor. (1)

If an in-house internal audit team is being used, it is vital that they retain their independence and do not just report to the Finance Director, because otherwise they would find it difficult to criticise the Finance Director or other senior managers. (1) They need to be objective when they investigate and monitor the company's controls. They therefore need to be independent of executive management and in order to do so should have a reporting line to the non- executive Chair or to the other non-executive director of Pegotty. (1)