CPA PROGRAM – PROFESSIONAL LEVEL

ETHICS AND GOVERNANCE

WORKSHOP 2

GOVERNANCE

WORKSHOP NOTES 2014

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Case Study 1: Purpleflex PLC

Purpleflex PLC is a large publicly listed company that produces a variety of products for the building industry. Harry Humber has been the CEO and Chairman of Purpleflex since the company's inception almost 12 years ago.

In addition to Harry, the senior executives of Purpleflex include:
- Benjamin Bamert – chief financial officer (CFO)
- Angela Adventis – chief investment officer (CIO)
- Penny Pontomac – chief operating officer (COO).

The current board of directors is made up of the four executive directors noted above and three non-executive directors:
- Ronald Ravens – also a substantial shareholder of Purpleflex with 23 per cent shareholding
- Sonia Spiteri – a nominee director representing the interests of a debt-funding syndicate to Purpleflex
- William Wolters – an independent director with a number of years' experience in the building industry.

The board has an audit committee which meets regularly during the year:
- chaired by Benjamin
- also includes Sonia and William – neither Sonia nor William has relevant financial experience.

Case study task

Discuss whether the board and sub-committee structure and composition of Purpleflex PLC breaches the UK Financial Reporting Council C*orporate Governance Code* (UK FRC CGC or the 'Code', 2012) and what rectification measures (if any) are required. Your answer should refer to case facts and relevant paragraph number(s) of the *Code*.

Workshop solutions

Exercise 1

Question 1

Why do shareholders need rights and remedies? Describe at least three rights of shareholders.

Shareholder rights relate to the rights of ownership and the ability to control, or have input into, the holding and treatment of that asset. Shareholders are an important funding mechanism for companies and shareholder rights help to protect the integrity of that system. However, the integrity of the system would likely fail if there were no remedies to address breaches of shareholder rights.

Basic shareholder rights include the right to:

- secure methods of ownership registration. This relates to having and safeguarding the title over the shareholding, such as the services provided by share-registries
- convey or transfer shares. This is the ability to buy, sell or transfer shares (either on-market or off-market)
- obtain relevant and material information on the corporation on a timely and regular basis. This relates to regular annual and half-year reports, as well as ad hoc market updates that may be material to the share price
- participate and vote in general shareholder meetings. This is part of the control function of shareholder rights, allowing the shareholder to have input into the functioning of the company
- elect and remove members of the board. This is especially important where ownership and management of the corporation are separated and the directors are acting as agents for the shareholders
- share in the profits of the corporation. This relates to the shareholders' primary aim of receiving returns in the form of income and capital (*OECD Principles of Corporate Governance 2004*, Core Principle 2).

Question 2

What is the purpose of the nomination committee?

The nomination committee is the means by which formal, rigorous and transparent procedures for the appointment of new directors to the board can be implemented. Its purpose is to lead the process for board appointments and make recommendations to the board. The committee may also be responsible for succession planning for key executive positions.

Question 3

Why are institutional shareholders considered differently to other shareholders?

Institutional shareholders are considered differently to other shareholders mainly because of their size and the diversity of their shareholdings. They are typically substantial shareholders of corporations and therefore have the opportunity (or some may say, the obligation) to be more involved in the governance of the corporation.

Case Study 1: Purpleflex PLC

Purpleflex PLC can be assessed against the *UK FRC CGC* (2012) under the following headings.

Composition of the board

Provision B.1.2 of the *UK FRC CGC* (noted in the Study Guide on p. 5 of Appendix 3.1) states that:

> At least half the board, excluding the chairman, should comprise independent non-executive directors determined by the board to be independent.

Purpleflex has a board with seven directors (four executive and three non-executive). However, only one of the three non-executive directors would be considered independent (William). The other two non-executive directors seem to have relationships or circumstances that can affect the independence of a director. Ronald is a substantial shareholder and Sonia represents a debt-funding syndicate.

To meet the expectations of the *UK FRC CGC*, Purpleflex should consider replacing two of the non-independent directors with independent non-executive directors, or increasing the number of directors on the board by adding independent directors.

Division of responsibilities

Division A.2 provides that decision power should be controlled and that board and executive responsibilities should not be used in an unfettered way. Provision A.2.1 provides that the CEO and chairman should not be same person.

Purpleflex currently has the one individual in both the CEO and chairman roles – Harry. Ideally, the roles of chairman and CEO should not be exercised by the same individual.

To meet the expectations of the *UK FRC CGC*, Purpleflex should separate the roles of CEO and chairman and fill the role of chairman with an independent non-executive director.

Audit committee

Paragraph C.3.1 requires that an audit committee should consist of, in the case of larger companies, at least three independent non-executive directors and at least one member with recent and relevant financial expertise.

Purpleflex has an audit committee, but it does not meet the expectations of the UK FRC CGC. The CFO, as an executive director, should not be on the committee. Also, of the remaining two members of the audit committee, only William would be considered an independent non-executive director. To meet the expectations of the *Code*, Purpleflex would need to replace Benjamin with an independent non-executive director who has recent and relevant financial experience. In addition, Sonia should be replaced by an independent non-executive director.

Remuneration committee

Paragraph D.2.1 provides that the board should establish a remuneration committee of at least three, or in the case of smaller companies, two independent non-executive directors. In addition, the company chairman may also be a member of, but not chair, the committee if he or she was considered independent on appointment as chairman.

Purpleflex does not currently have a remuneration committee. To meet the expectations of the UK FRC CGC, Purpleflex should have a remuneration committee consisting of at least three independent non-executive directors (i.e. William and two other independent non-executive directors). Ronald and Sylvia are not independent directors and Harry is an executive director who has been the CEO and chairman since the inception of the company. As such, Harry does not meet the criteria of being considered independent on appointment as chairman and should not join this committee.