CIMA

Subject E1

Managing Finance in a Digital World

Study Text

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Contents

Introduction

How to use the Materials

These official CIMA learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chances of success in your objective tests.

The product range contains a number of features to help you in the study process. They include:

- a detailed explanation of all syllabus areas
- extensive 'practical' materials
- generous question practice, together with full solutions.

This Study Text has been designed with the needs of home study and distance learning candidates in mind. Such students require very full coverage of the syllabus topics, and also the facility to undertake extensive question practice. However, the Study Text is also ideal for fully taught courses.

The main body of the text is divided into a number of chapters, each of which is organised on the following pattern:

- **Detailed learning outcomes.** These describe the knowledge expected after your studies of the chapter are complete. You should assimilate these before beginning detailed work on the chapter, so that you can appreciate where your studies are leading.
- **Step-by-step topic coverage.** This is the heart of each chapter, containing detailed explanatory text supported where appropriate by worked examples and exercises. You should work carefully through this section, ensuring that you understand the material being explained and can tackle the examples and exercises successfully. Remember that in many cases knowledge is cumulative: if you fail to digest earlier material thoroughly, you may struggle to understand later chapters.
- **Activities.** Some chapters are illustrated by more practical elements, such as comments and questions designed to stimulate discussion.
- **Question practice.** The text contains three styles of question:
  - Exam-style objective test questions (OTQs).
  - 'Integration' questions – these test your ability to understand topics within a wider context. This is particularly important with calculations where OTQs may focus on just one element but an integration question tackles the full calculation, just as you would be expected to do in the workplace.

– ‘Case’ style questions – these test your ability to analyse and discuss issues in greater depth, particularly focusing on scenarios that are less clear cut than in the objective tests, and thus provide excellent practice for developing the skills needed for success in the Management Level Case Study Examination.

- **Solutions.** Avoid the temptation merely to ‘audit’ the solutions provided. It is an illusion to think that this provides the same benefits as you would gain from a serious attempt of your own. However, if you are struggling to get started on a question you should read the introductory guidance provided at the beginning of the solution, where provided, and then make your own attempt before referring back to the full solution.

If you work conscientiously through this Official CIMA Study Text according to the guidelines above you will be giving yourself an excellent chance of success in your objective tests. Good luck with your studies!

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Our Quality Co-ordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.

Icon explanations

Definition – These sections explain important areas of knowledge which must be understood and reproduced in an assessment environment.

Key point – Identifies topics which are key to success and are often examined.

Supplementary reading – These sections will help to provide a deeper understanding of core areas. The supplementary reading is **NOT** optional reading. It is vital to provide you with the breadth of knowledge you will need to address the wide range of topics within your syllabus that could feature in an assessment question. **Reference to this text is vital when self-studying.**

Test your understanding – Following key points and definitions are exercises which give the opportunity to assess the understanding of these core areas.

Illustration – To help develop an understanding of particular topics. The illustrative examples are useful in preparing for the Test your understanding exercises.

Exclamation mark – This symbol signifies a topic which can be more difficult to understand. When reviewing these areas, care should be taken.

New – Identifies topics that are brand new in subjects that build on, and therefore also contain, learning covered in earlier subjects.

Tutorial note – Included to explain some of the technical points in more detail.

Study technique

Passing exams is partly a matter of intellectual ability, but however accomplished you are in that respect you can improve your chances significantly by the use of appropriate study and revision techniques. In this section we briefly outline some tips for effective study during the earlier stages of your approach to the objective tests. We also mention some techniques that you will find useful at the revision stage.

Planning

To begin with, formal planning is essential to get the best return from the time you spend studying. Estimate how much time in total you are going to need for each subject you are studying. Remember that you need to allow time for revision as well as for initial study of the material.

With your study material before you, decide which chapters you are going to study in each week, and which weeks you will devote to revision and final question practice.

Prepare a written schedule summarising the above and stick to it!

It is essential to know your syllabus. As your studies progress you will become more familiar with how long it takes to cover topics in sufficient depth. Your timetable may need to be adapted to allocate enough time for the whole syllabus.

Students are advised to refer to the examination blueprints (see page P.13 for further information) and the CIMA website, www.cimaglobal.com, to ensure they are up-to-date.

The amount of space allocated to a topic in the Study Text is not a very good guide as to how long it will take you. The syllabus weighting is the better guide as to how long you should spend on a syllabus topic.

Tips for effective studying

(1) Aim to find a quiet and undisturbed location for your study, and plan as far as possible to use the same period of time each day. Getting into a routine helps to avoid wasting time. Make sure that you have all the materials you need before you begin so as to minimise interruptions.

(2) Store all your materials in one place, so that you do not waste time searching for items every time you want to begin studying. If you have to pack everything away after each study period, keep your study materials in a box, or even a suitcase, which will not be disturbed until the next time.

(3) Limit distractions. To make the most effective use of your study periods you should be able to apply total concentration, so turn off all entertainment equipment, set your phones to message mode, and put up your ‘do not disturb’ sign.

(4) Your timetable will tell you which topic to study. However, before diving in and becoming engrossed in the finer points, make sure you have an overall picture of all the areas that need to be covered by the end of that session. After an hour, allow yourself a short break and move away from your Study Text. With experience, you will learn to assess the pace you need to work at. Each study session should focus on component learning outcomes – the basis for all questions.

(5) Work carefully through a chapter, making notes as you go. When you have covered a suitable amount of material, vary the pattern by attempting a practice question. When you have finished your attempt, make notes of any mistakes you made, or any areas that you failed to cover or covered more briefly. Be aware that all component learning outcomes will be tested in each examination.

(6) Make notes as you study, and discover the techniques that work best for you. Your notes may be in the form of lists, bullet points, diagrams, summaries, ‘mind maps’, or the written word, but remember that you will need to refer back to them at a later date, so they must be intelligible. If you are on a taught course, make sure you highlight any issues you would like to follow up with your lecturer.

(7) Organise your notes. Make sure that all your notes, calculations etc. can be effectively filed and easily retrieved later.

Progression

There are two elements of progression that we can measure: how quickly students move through individual topics within a subject; and how quickly they move from one course to the next. We know that there is an optimum for both, but it can vary from subject to subject and from student to student. However, using data and our experience of student performance over many years, we can make some generalisations.

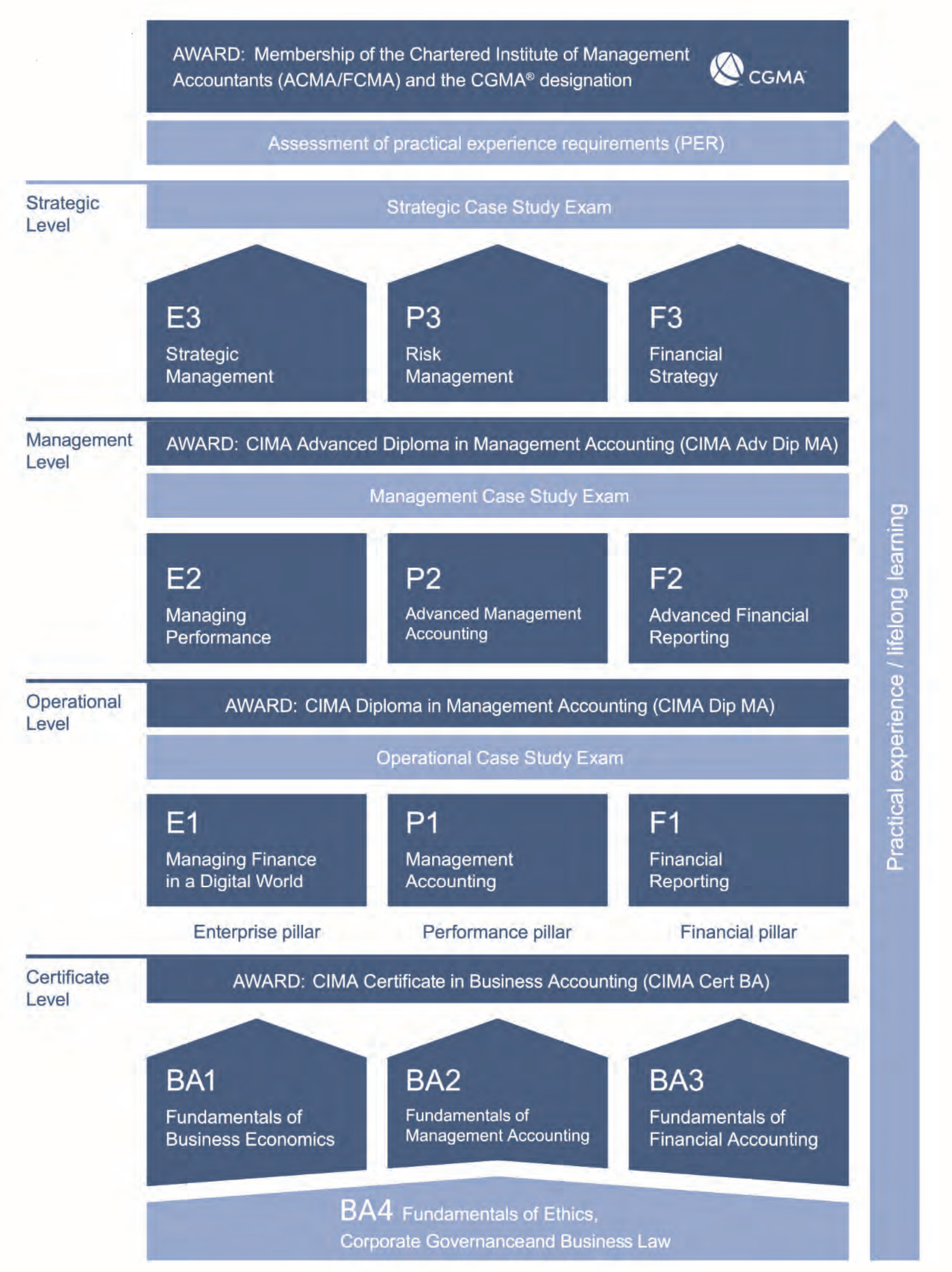
A fixed period of study set out at the start of a course with key milestones is important. This can be within a subject, for example ‘I will finish this topic by 30 June’, or for overall achievement, such as ‘I want to be qualified by the end of next year’.

Your qualification is cumulative, as earlier papers provide a foundation for your subsequent studies, so do not allow there to be too big a gap between one subject and another. For example, E1 *Managing finance in a digital world* builds on your knowledge of the finance function from certificate level and lays the foundations for E2 *Managing performance* and all strategic papers particularly E3 *Strategic management* and P3 *Risk management*.

We know that exams encourage techniques that lead to some degree of short term retention, the result being that you will simply forget much of what you have already learned unless it is refreshed (look up Ebbinghaus Forgetting Curve for more details on this). This makes it more difficult as you move from one subject to another: not only will you have to learn the new subject, you will also have to relearn all the underpinning knowledge as well. This is very inefficient and slows down your overall progression which makes it more likely you may not succeed at all.

In addition, delaying your studies slows your path to qualification which can have negative impacts on your career, postponing the opportunity to apply for higher level positions and therefore higher pay.

You can use the following diagram showing the whole structure of your qualification to help you keep track of your progress. Make sure you carefully review the 2019 CIMA syllabus transition rules and seek appropriate advice if you are unsure about your progression through the qualification.



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Objective test

Objective test questions require you to choose or provide a response to a question whose correct answer is predetermined.

The most common types of objective test question you will see are:

- Multiple choice, where you have to choose the correct answer(s) from a list of possible answers. This could either be numbers or text.
- Multiple choice with more choices and answers, for example, choosing two correct answers from a list of eight possible answers. This could either be numbers or text.
- Single numeric entry, where you give your numeric answer, for example, profit is $10,000.
- Multiple entry, where you give several numeric answers.
- True/false questions, where you state whether a statement is true or false.
- Matching pairs of text, for example, matching a technical term with the correct definition.
- Other types could be matching text with graphs and labelling graphs/diagrams.

In every chapter of this Study Text we have introduced these types of questions, but obviously we have had to label answers A, B, C etc. rather than using click boxes. For convenience, we have retained quite a few questions where an initial scenario leads to a number of sub-questions. There will be no questions of this type in the objective tests.

Guidance re CIMA on-screen calculator

As part of the CIMA objective test software, candidates are now provided with a calculator. This calculator is on-screen and is available for the duration of the assessment. The calculator is available in each of the objective tests and is accessed by clicking the calculator button in the top left hand corner of the screen at any time during the assessment. Candidates are permitted to utilise personal calculators as long as they are an approved CIMA model. Authorised CIMA models are listed here: https://www.cimaglobal.com/Studying/study-and-resources/.

All candidates must complete a 15-minute exam tutorial before the assessment begins and will have the opportunity to familiarise themselves with the calculator and practise using it. The exam tutorial is also available online via the CIMA website.

Candidates may practise using the calculator by accessing the online exam tutorial.

Fundamentals of objective tests

The objective tests are 90-minute assessments comprising 60 compulsory questions, with one or more parts. There will be no choice and all questions should be attempted. All elements of a question must be answered correctly for the question to be marked correctly. All questions are equally weighted.

CIMA syllabus 2019 – Structure of subjects and learning outcomes

Details regarding the content of the new CIMA syllabus can be located within the CIMA 2019 professional syllabus document.

Each subject within the syllabus is divided into a number of broad syllabus topics. The topics contain one or more lead learning outcomes, related component learning outcomes and indicative knowledge content.

A learning outcome has two main purposes:

(a) To define the skill or ability that a well prepared candidate should be able to exhibit in the examination.

(b) To demonstrate the approach likely to be taken in examination questions.

The learning outcomes are part of a hierarchy of learning objectives. The verbs used at the beginning of each learning outcome relate to a specific learning objective, e.g.

Calculate the break-even point, profit target, margin of safety and profit/volume ratio for a single product or service.

The verb '**calculate**' indicates a level three learning objective. The following tables list the verbs that appear in the syllabus learning outcomes and examination questions.

The examination blueprints and representative task statements

CIMA have also published examination blueprints giving learners clear expectations regarding what is expected of them.

The blueprint is structured as follows:

- Exam content sections (reflecting the syllabus document)
- Lead and component outcomes (reflecting the syllabus document)
- Representative task statements.

A representative task statement is a plain English description of what a CIMA finance professional should know and be able to do.

The content and skill level determine the language and verbs used in the representative task.

CIMA will test up to the level of the task statement in the objective tests (an objective test question on a particular topic could be set at a lower level than the task statement in the blueprint).

The format of the objective test blueprints follows that of the published syllabus for the 2019 CIMA Professional Qualification.

Weightings for content sections are also included in the individual subject blueprints.

CIMA VERB HIERARCHY

CIMA place great importance on the definition of verbs in structuring objective tests. It is therefore crucial that you understand the verbs in order to appreciate the depth and breadth of a topic and the level of skill required. The objective tests will focus on levels one, two and three of the CIMA hierarchy of verbs. However, they will also test levels four and five, especially at the management and strategic levels.

Skill level	Verbs used	Definition
Level 5 **Evaluation** How you are expected to use your learning to evaluate, make decisions or recommendations	Advise	Counsel, inform or notify
	Assess	Evaluate or estimate the nature, ability or quality of
	Evaluate	Appraise or assess the value of
	Recommend	Propose a course of action
	Review	Assess and evaluate in order, to change if necessary
Level 4 **Analysis** How you are expected to analyse the detail of what you have learned	Align	Arrange in an orderly way
	Analyse	Examine in detail the structure of
	Communicate	Share or exchange information
	Compare and contrast	Show the similarities and/or differences between
	Develop	Grow and expand a concept
	Discuss	Examine in detail by argument
	Examine	Inspect thoroughly
	Interpret	Translate into intelligible or familiar terms
	Monitor	Observe and check the progress of
	Prioritise	Place in order of priority or sequence for action
	Produce	Create or bring into existence
Level 3 **Application** How you are expected to apply your knowledge	Apply	Put to practical use
	Calculate	Ascertain or reckon mathematically
	Conduct	Organise and carry out
	Demonstrate	Prove with certainty or exhibit by practical means
	Prepare	Make or get ready for use
	Reconcile	Make or prove consistent/compatible

Skill level	Verbs used	Definition
Level 2 **Comprehension** What you are expected to understand	Describe	Communicate the key features of
	Distinguish	Highlight the differences between
	Explain	Make clear or intelligible/state the meaning or purpose of
	Identify	Recognise, establish or select after consideration
	Illustrate	Use an example to describe or explain something
Level 1 **Knowledge** What you are expected to know	List	Make a list of
	State	Express, fully or clearly, the details/facts of
	Define	Give the exact meaning of
	Outline	Give a summary of

Information concerning formulae and tables will be provided via the CIMA website, www.cimaglobal.com.

SYLLABUS GRIDS

E1: Managing Finance in a Digital World

How the finance function is organised

Content weighting

Content area		Weighting
A	Role of the finance function	20%
B	Technology in a digital world	20%
C	Data and Information in a digital world	20%
D	Shape and structure of the finance function	20%
E	Finance Interacting with the organisation	20%
		100%

E1A: Role of the finance function

This section examines the roles that finance plays in organisations and why. It describes in detail the activities that finance professionals perform to fulfil these roles. Consequently, it is the foundation of the whole qualification and answers the question: what do finance professionals do and why? It provides links with other topics within the subject and what is covered in other areas of the Operational Level.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Explain the roles of the finance function in organisations.	Explain how the finance function: a. Enables organisations to create and preserve value b. Shapes how organisations create and preserve value c. Narrates how organisations create and preserve value	• The fast-changing and unpredictable contexts in which organisations operate • Enabling value creation through planning, forecasting and resource allocation • Shaping value creation through performance management and control • Narrating the value creation story through corporate reporting • The role of ethics in the role of the finance function	Describe the increasingly disruptive contexts in which organisations and their finance teams operate and how these contexts shape the role of finance. Take each role and show how finance performs it in a typical organisational setting. The coverage should be introductory and brief. It is meant to set the scene for subsequent sections and draw a link between the roles and the topics that will be covered in other areas of the Operational Level.
2. Describe the activities that finance professionals perform to fulfil the roles.	Describe how the finance function: a. Collates data to prepare information about organisations b. Provides insight to users by analysing information c. Communicates insight to influence users d. Supports the implementation of decisions to achieve the desired impact e. Connects the different activities connect to each other	• How data is collected, cleaned and connected by finance • Types of analysis to produce insights • How finance communicates to influence key stakeholders (audiences, frequency, format, etc.) • How finance uses resource allocation and performance management to enable organisations to achieve their objectives • Potential impact of technology	Use 'information to impact' framework to describe the primary activities finance professionals perform. Relate it to how data is generated, transformed and used. Link it to how technology could be used to improve the productivity of finance professionals in these areas and the threat of automation.

E1B: Technology in a digital world

This section focuses on the technologies that define and drive the digital world in which finance operates. It provides awareness of the technologies used in organisations and deepens understanding of the impact of the technologies on what finance does. It draws on the issues raised in the previous section about the role of finance and the activities finance performs to fulfil these roles. Given that the digital world is underpinned by technology and the use of data, this section provides a foundation to the next section on data.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Outline and explain the technologies that affect business and finance.	a. Outline the key features of the fourth industrial revolution. b. Outline and explain the key technologies that define and drive the digital world.	• Characteristics and dynamics of the fourth industrial revolution • Cloud computing • Big data analytics • Process automation • Artificial intelligence • Data visualisation • Blockchain • Internet of things • Mobile • 3-D printing	The aim is to create awareness of the technologies that drive the digital world and how they interact with each other. The technologies outlined by the major advisory firms and the World Economic Forum digital transformation initiative provide the material on which learning and related activities can be based.
2. Examine how the finance function uses digital technologies to fulfil its roles.	Examine how finance uses the following to guide how it performs its roles: a. Digital technology b. Digital mindsets c. Automation and the future of work d. Ethics of technology usage	• How finance uses technologies listed above • Areas of finance susceptible to automation and why • New areas for finance to focus on • Digital mindsets for finance • Ethics of the use of technology	Examine how finance professionals use the relevant technologies to fulfil their roles. Explain how the technologies affect various activities finance professionals perform in the 'information to impact' framework. The intention is to move from creating awareness to generating understanding of how finance can use these technologies to increase its value and relevance to organisations.

E1C: Data and information in a digital world

This section draws out one of the major implications of using technology in organisations and the finance function – namely the collection and processing of information can be done more effectively by machines rather than by people. It asserts that the role of finance professionals should be to use data to create and preserve value for organisations. Five ways of using data are examined. The key competencies required to use data in these ways are also highlighted. The primary objective is to help finance professionals understand what they can do with data and how to build the skills needed to use data.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Describe the ways in which data is used by the finance function.	Identify the ways in which the finance function uses data: a. In a general sense b. Specifically in each of the primary activities of finance	Using data for: • Decision-making • Understanding the customer • Developing customer value proposition • Enhancing operational efficiency • Monetising data • Ethics of data usage	Build on the previous section on technology to explain why, in the digital world, finance professionals must place more focus on using information than on collecting and/or processing information. Outline and describe the various uses of information. Link them to the primary activities that the finance function performs and to the topics to be covered in other modules of the Operational Level.
2. Explain the competencies required to use data to create and preserve value for organisations.	Explain the competencies that finance professionals need in: a. Data strategy and planning b. Data engineering, extraction and mining c. Data modelling, manipulation and analysis d. Data and insight communication	• Assessment of data needs • Extraction, transformation and loading (ETL) systems • Business Intelligence (BI) systems • Big data analytics • Data visualisation	Highlight and explain the data competencies required in the digital world. Locate where finance has a competitive advantage and where finance will need to work with data scientists.

E1D: Shape and structure of the finance function

This section brings together the implications of the previous sections. It reveals how the finance function is structured and shaped. This structure and shape enables finance to perform its role in the organisation and with other internal and external stakeholders. In this sense, it prepares candidates for the next section, which looks at how finance interacts with key internal stakeholders in operations, marketing and human resources.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Describe the structure and shape of the finance function.	Describe the: a. Evolution of the shape of the finance function b. Shape of the finance function in the digital era	• Structure of the finance function from the roles that generate information to the roles that turn information into insight and communicate insight to decision-makers • Hierarchical shape of finance function • Shared services and outsourcing of finance operations • Retained finance • Automation and diamond shape of finance function	Introduce candidates to the structure of the finance function and outline the broad areas of finance such as finance operations, external reporting, financial planning and analysis (FP&A), decision support etc. Describe the evolving shape of the finance function from the triangle to the diamond shape. Link the description to the impact of digital technology and automation on the finance function.
2. Explain what each level of the finance function does.	Explain the activities of: a. Finance operations b. Specialist areas including financial reporting and financial planning and analysis (FP&A) c. Strategic partnering for value d. Strategic leadership of the finance team	• Finance operations to generate information and preliminary insight • FP&A, taxation, corporate reporting, decision support to produce insight • Business partnering to influence organisation to make appropriate decisions • Leading the finance team to create the required impact for the organisation	The focus is the diamond shape and the four levels within this shape. Explain what each level does, the relationship between the levels, and the link between the levels and the basic finance activities covered under the role of finance.

E1E: Finance interacting with the organisation

The finance function is not the only area of activity in organisations. Finance joins with others to create and preserve value for their organisations. This section brings together what has been learned in the previous section to describe how finance can interact with other parts of the organisation to achieve the objectives of finance, those other areas and crucially the objectives of the whole organisation. The aim is to show how finance can work collaboratively in a connected (and joined-up) organisation and not in isolation.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Describe how the finance function interacts with operations.	Describe: a. Main role of operations b. Areas of interface with finance c. Key performance indicators	• Process management • Product and service management • Supply chain management	Describe how finance plays its role by interacting with the rest of the organisation. Bring together the issues raised in the previous sections and link them to what the other areas of the organisations do. For example, address how finance and marketing interact using data and collaborative technology to achieve organisational goals and the individual functional goals of both finance and marketing. Describe how the use of KPIs influence these interactions and how the KPIs of finance and these areas can be aligned to ensure they work together effectively.
2. Describe how the finance function interacts with sales and marketing.	Describe: a. Main role of sales and marketing b. Areas of interface with finance c. Key performance indicators	• Market segmentation • Big data analytics in marketing • Channel management • Sales forecasting and management	
3. Describe how the finance function interacts with human resources.	Describe: a. Main role of human resources b. Areas of interface with finance c. Key performance indicators	• Staff acquisition • Staff development • Performance management • Motivation and reward systems	
4. Describe how the finance function interacts with IT.	Describe: a. Main role of IT b. Areas of interface with finance c. Key performance indicators	• IT infrastructure • IT systems support • Costs and benefits of IT systems	

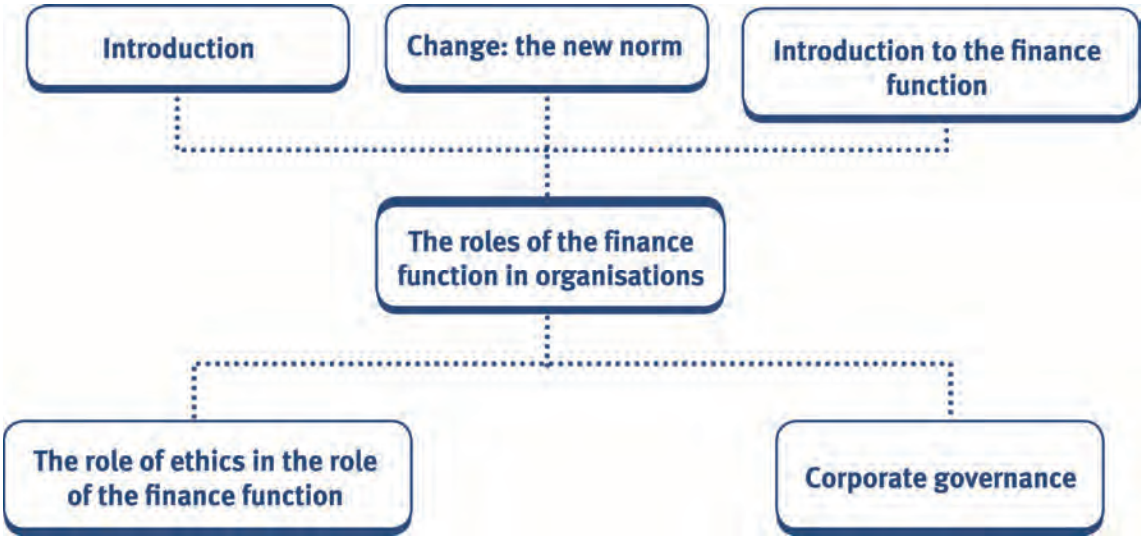
Chapter

1

The roles of the finance function in organisations

Chapter learning objectives

Lead	Component
A1: The roles of the finance function in organisations.	(a) Enables organisations to create and preserve value. (b) Shapes how organisations create and preserve value. (c) Narrates how organisations create and preserve value.



1 Introduction

Before we look at the roles of the finance function in organisations, it is useful to understand the overall purpose of E1 and how it fits within CIMA's Professional Qualification.

1.1 The CIMA Professional Qualification

The CIMA Professional Qualification will give you the skills that you need to work as a confident and competent management accountant in an age where change is the new norm so that you can guide and lead your organisation's success.

We live in an age of technological advancements and innovation and these factors are transforming the way in which we work and live. The World Economic Forum calls it the **4th Industrial Revolution** and this revolution is having a huge impact on the finance function and, as a result, the skillset of a management accountant.

1.2 The Operational Level

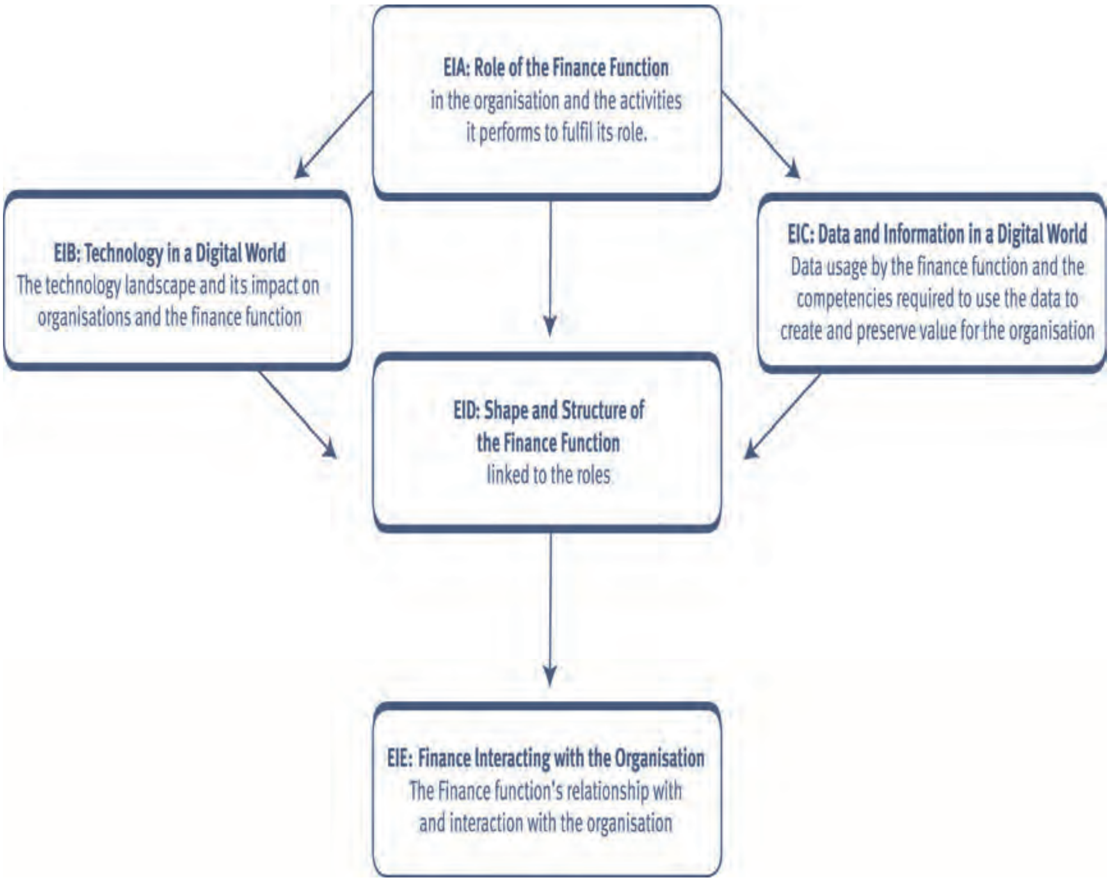
'Finance' runs through the Operational Level:

- **P1** – focuses on '**what**' the finance function does
- **F1** – focuses on '**what**' the finance function does and its **implications**
- **E1** – focuses on '**how**' the finance function is organised

At the Operational Level the emphasis will be on **remembering** and **understanding** but **some insight** regarding specific problems or situations may also be required.

1.3 Paper E1: Managing Finance in a Digital World

There are five connected areas to the syllabus:



1.4 The roles of the finance function in organisations

This chapter covers **syllabus area A1**, '**explain the roles of the finance function in organisations**'. By the end of this chapter you should understand how the finance function enables, shapes and narrates value creation through its **roles** of:

- planning
- forecasting
- resource allocation
- performance management and control and
- financial (corporate) reporting.

These roles are changing due to the **continuous change** that is impacting all organisations and so before introducing the roles of the finance function we will begin our discussion of this syllabus area by briefly looking at change.

The chapter concludes with a discussion of **ethics**, **corporate social responsibility** and **corporate governance** since these areas will be fundamental underpinning factors in an organisation's sustained value and are therefore related to the finance function's role in value creation and preservation.

2 Change: The new norm

Change is the new norm in many organisations due to seismic shifts in the level of **competition**, customers' expectations and the global political outlook combined with a fast pace of **technological change** (with machines increasingly taking over routine tasks and new technologies emerging across the global economy this is considered to be the key driver of change).

This **rapid** and often **unpredictable** evolution has resulted:

- in organisations having to plan for a different way of doing business and
- has resulted in an evolution of the roles of the finance function.

These changes present both risks and opportunities and will be explored in greater depth in subsequent chapters but before we explore what the changes are and how they will impact the organisation and the finance function within it, we need to firstly understand what the overall roles of the finance function are within an organisation.

e.g

Illustration 1 – Change and impact on organisations
Extraordinary economic changes are happening at such a fast pace driven by technology innovations and advances. The digital world created has been cited as the main reason just over half of companies on the Fortune 500 have disappeared since the year 2000. Those companies that have disappeared, such as Blockbusters in 2010 and Kodak in 2012, may well have been using outdated 20th century business thinking and concepts trying to build sustainable organisations in the 21st century digital world.

3 Introduction to the finance function

Before focusing on the finance function it is useful to remind ourselves of the different types of organisations that exist and also of the different functions that exist within an organisation.

3.1 Different types of organisation

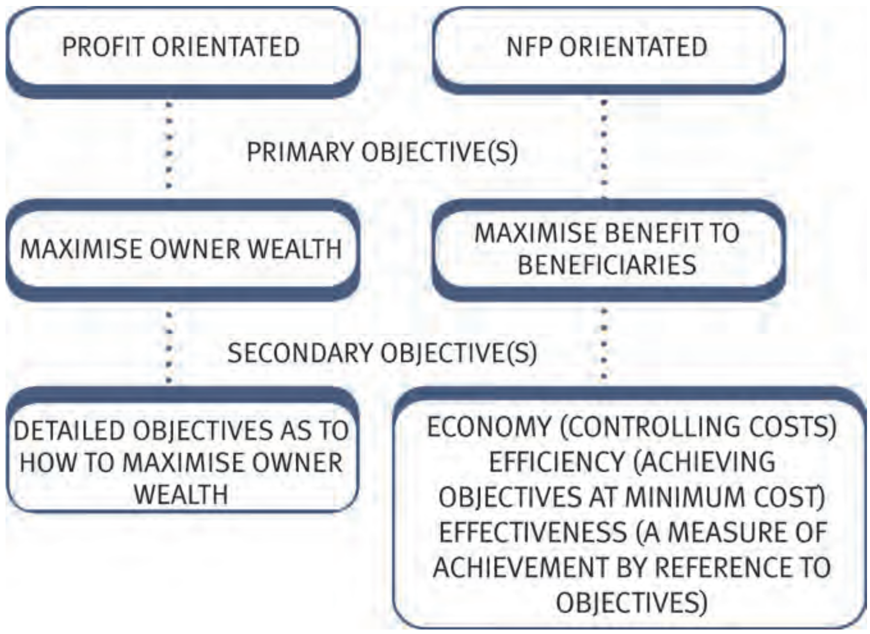
As we know from our earlier studies there are many different types of organisation:

- **Profit seeking organisations, i.e. businesses** include companies, partnerships and sole traders. Their main objective is the maximisation of the wealth of their owners.

- **Not-for-profit organisations (NFPOs)** include public sector organisations (such as schools and hospitals) and private sector organisations (such as charities and clubs). These organisations do not see profit as their main objective.

Throughout the text the concepts that are introduced are done so mainly in relation to businesses. However, it is worth noting that much of the discussion is just as relevant to NFPOs.

Profit versus not-for-profit organisations



Test your understanding 1

Which of the following are not-for-profit organisations? Choose all that apply.

A private school

B medical research charity

C local hospital

D sole trader who is making a loss

E private limited company

F local government agency

3.2 The functions of an organisation

The main functions of a business are:

- operations
- sales and marketing
- human resources (HR)
- IT and
- **finance**.

This reflects the model of the business as taking three basic types of resource – material, labour and money – to produce goods and services which generate profit.

It is a major part of the finance function's work to look after the business's money. The finance function's role in managing the financial resources of the organisation and providing information to help economic decision making will be integral to the effectiveness of the finance function.

3.3 The roles of the finance function in organisations

The finance function plays **three key roles**. A finance function:

- **ENABLES** an organisation to create and preserve value though planning, forecasting and resource allocation:
  - **Planning:** the finance function will have an important role in preparing plans to assist the organisation in achieving its objectives and formulating relevant strategies. One of the main types of planning carried out at the operational level will be budgeting.
  - **Forecasting:** the preparation of forecasts, for example of future sales or material prices, will be an important role of the finance function at the operational level.
  - **Resource allocation:** an important role of the finance function will be in working out which resources (for example, labour, material, machinery, finance) the organisation will require to achieve its objectives.

  In the CIMA Professional Qualification, the 'enables' element is encompassed in the Enterprise pillar.

- **SHAPES HOW** an organisation creates and preserves value through performance management and control:
  - **Performance management:** the finance function has an important role in the management of performance and the achievement of the organisation's plans and budgets.

For example, it will help to prepare information for internal management such as performance measures. These measures will assist in monitoring the performance of the organisation. The performance measures may be quantitative, i.e. numerical (such as sales, profit or units produced) or may be qualitative, i.e. non-numerical (such as customer satisfaction or levels of innovation).

  - **Control:** this will be an important part of effective performance management; actual performance will be compared to planned performance to identify any differences. Variance analysis may be carried out as part of this role. The identification of these differences may result in a reassessment or amendment of the original plans, strategies or budgets.

  In the CIMA Professional Qualification, the 'shapes how' element is encompassed in the Performance pillar.

- **NARRATES HOW** an organisation creates and preserves value through financial (corporate) reporting:
  - Financial reporting (also called corporate reporting): an important role of the finance function is in preparing comprehensive reports intended to give information to shareholders and/or other interested people about the organisation's activities and performance throughout the year.

  In the CIMA Professional Qualification, the 'narrates how' element is encompassed in the 'Financial' pillar.

If it plays these roles effectively, then finance professionals are valuable to organisations.

Important note: This is a brief introduction to the roles of the finance function. However, this area is highly examinable and will be returned to and built upon in subsequent chapters. It will underpin much of the discussion in these later chapters.

4 The role of ethics in the role of the finance function

4.1 The ethical responsibilities of the organisation and individuals

As mentioned previously (in section 1.4), ethics will be a fundamental underpinning factor in the organisation's sustained value creation.

The roles that the finance function performs should be carried out in an ethical way, with integrity and professionalism.

The professional accountant has a special role in promoting ethical behaviour throughout the business.

Ethics, business ethics and ethical dilemmas

Ethics is the system of moral principles that examines the concept of right and wrong.

Business ethics is the application of ethical values to business behaviour.

An **ethical dilemma** involves a situation where a decision-maker has to decide what is the 'right' or 'wrong' thing to do. Examples of ethical dilemmas can be found throughout all aspects of business operations:

Accounting issues

- Creative accounting to boost or suppress reported profits.
- Directors' pay arrangements – should directors continue to receive large pay packets even if the company is performing poorly?
- Should bribes be paid to facilitate contracts, especially in countries where such payments are commonplace?
- Insider trading, where for example directors may be tempted to buy shares in their company knowing that a favourable announcement about to be made should boost the share price.

Production issues

- Should the company produce certain products at all, for example guns, pornography, tobacco, alcoholic drinks aimed at teenagers?
- Should the company be concerned about the effects on the environment of its production processes?
- Should the company test its products on animals?

Sales and marketing issues

- Price fixing and anti-competitive behaviour may be overt and illegal or may be more subtle.
- Is it ethical to target advertising at children, for example for fast food or for expensive toys at Christmas?
- Should products be advertised by junk mail or spam email?

Personnel (HRM) issues

- Employees should not be favoured or discriminated against on the basis of gender, race, religion, age, disability, etc.
- The contract of employment must offer a fair balance of power between employee and employer.
- The workplace must be a safe and healthy place to operate in.

4.2 CIMA's ethical guidelines

Management accountants have a duty to observe the highest standards of conduct and integrity, and to uphold the good standing and reputation of their profession.

The Code of Ethics for Professional Accountants, published by The International Federation of Accountants (IFAC), forms the basis for the ethical codes of many accountancy bodies, including CIMA.

CIMA's Code of Ethics, based on IFAC's five ethical principles, seeks to help management accountants in their day to day role. It helps management accountants to identify areas where ethical pressures may exist and provides a recommended course of action for their resolution.

In order to achieve the objectives of the accounting profession, professional accountants have to observe five fundamental principles:

Fundamental Principle	Interpretation
Integrity	Integrity means being straightforward, honest and truthful in all professional and business relationships.
Objectivity	Objectivity means not allowing bias, conflict of interest, or the influence of other people to override your professional judgement.
Professional competence and due care	This is an ongoing commitment to maintain your level of professional knowledge and skill so that your client or employer receives a competent professional service. Work should be completed carefully, thoroughly and diligently, in accordance with relevant technical and professional standards.
Confidentiality	This means respecting the confidential nature of information you acquire through professional relationships such as past or current employment. You should not disclose such information unless you have specific permission or a legal or professional duty to do so. You should also never use confidential information for your or another person's advantage.
Professional behaviour	This requires you to comply with relevant laws and regulations. You must also avoid any action that could negatively affect the reputation of the profession.

Test your understanding 2

John is a CIMA Member in Practice, and advises a range of individual clients and organisations. John has been asked, by his brother, to prepare the accounts for his brother's company. John's brother says that he wants the reported profit to be as high as possible, as he will soon be applying to the bank for loan finance.

To do this would be in breach of which fundamental ethical principle (according to CIMA's Code of Ethics)?

A integrity

B objectivity

C professional competence and due care

D confidentiality

E professional behaviour

4.3 Why business ethics are important

In addition to the professional accountant having a role in promoting ethical behaviour within an organisation, the organisation as a whole, and all of the individuals within it, are expected to act in an ethical way.

Businesses are part of society. Society expects its individuals to behave properly, and similarly expects companies to operate to certain standards. Acceptable business ethics may comprise as a minimum:

- paying staff **decent wages** and pensions
- providing **good working conditions** for staff
- **paying suppliers** in line with agreed terms
- **sourcing supplies** carefully
- using sustainable or **renewable sources**
- being **open and honest** with customers.

However, apart from any moral duty to be ethical, the prime purpose of a company is to maximise shareholder wealth and the chance of this happening is increased by the adoption of ethical behaviour since:

- Ethical behaviour is likely to be favoured by:
  - *customers:* resulting in higher sales volumes and/or prices.
  - *employees:* resulting in the attraction/retention of the best employees and increased employee productivity.
  - *business collaborators:* resulting in increased opportunities for profitable projects.

- Ethical behaviour reduces risk and gives access to cheaper funds which, in turn, increase project profitability.
- Unethical behaviour will, at some point be discovered resulting in a damage to reputation and potential legal charges.

Illustration 2 – Why business ethics are important

The Fairtrade mark is a label on consumer products that guarantees that disadvantaged producers in the developing world are getting a fair deal. For example, the majority of coffee around the world is grown by small farmers who sell their produce through a local co-operative. Fairtrade coffee guarantees to pay a price to producers that covers the cost of sustainable production and also an extra premium that is invested in local development projects.

Consumers in the developed world may be willing to pay a premium price for Fairtrade products, knowing that the products are grown in an ethical and sustainable fashion.

Test your understanding 3

Which of the following would potentially be ethical concerns for a cosmetics manufacturer? Choose all that apply.

A The amount of chemicals included in their products.

B The quality of the cosmetics.

C How much it pays its staff.

D How much its supplier pays its staff.

E The way the cosmetics are advertised.

4.4 Corporate codes of ethics

Most companies (especially if they are large) have approached the concept of business ethics by creating a written code of ethics (a set of internal policies) and instructing employees to follow them. These policies can either be **broad** generalisations (**a corporate ethics statement**) or can contain **specific** rules (**a corporate ethics code**).

There is no standard list of contents – it will vary between different organisations. Typically, however, it may contain guidelines on issues such as honesty, integrity and customer focus.

Many organisations appoint Ethics Officers (also known as Compliance Officers) to monitor the application of the policies and to be available to discuss ethical dilemmas with employees where needed.

4.5 Corporate social responsibility

This follows on from our discussion of ethics but before we review 'corporate social responsibility', we need to define the term 'stakeholder'.

A **stakeholder** is a group or individual, who has an interest in what the organisation does, or an expectation of the organisation.

The needs/expectations of different stakeholder groups may conflict. In the event of conflict, an organisation will need to decide which stakeholders' needs are more important. This will commonly be the most dominant stakeholder. If the organisation is having difficulty deciding who the dominant stakeholder is, they can use **Mendelow's power-interest matrix**.

		Level of interest: Low	Level of interest: High
Level of power	Low	Minimal effort	Keep informed
	High	Keep satisfied	Key players

By plotting each stakeholder according to the power that they have over an organisation and the interest they have in a particular decision, the dominant stakeholder(s), i.e. the key player(s) can be identified. The needs of the key players must be considered during the formulation and evaluation of new strategies.

Illustration 3 – Stakeholders' influence
The airline, Ryanair, has regular labour relations problems with pilots, cabin attendants and check-in staff. For example, in recent years pilots at Ryanair threatened a mass strike (and possible desertion to a competitor airline) if there were not significant improvements in pay and conditions. Ryanair cannot operate without these staff so these employees have great power and have shown that they are happy to exercise that power.

Types of stakeholder

Stakeholders can be broadly categorised into three categories; internal, connected and external.

Internal stakeholders

Internal stakeholders are intimately connected to the organisation, and their objectives are likely to have a strong influence on how it is run. Internal stakeholders include:

Stakeholder	Need/expectation
employees	pay, working conditions and job security
managers/directors	status, pay, bonus, job security

Connected stakeholders

Connected stakeholders either invest in or have dealings with the firm. They include:

Stakeholder	Need/expectation
shareholders	dividends and capital growth and the continuation of the business
customers	value-for-money products and services
suppliers	paid promptly
finance providers	repayment of finance

External stakeholders

These stakeholders tend to not have a direct link to the organisation but can influence or be influenced by its activities. They include:

Stakeholder	Need/expectation
community at large	will not want their lives to be negatively impacted by business decisions
environmental pressure groups	the organisation does not harm the external environment
government	provision of taxes and jobs and compliance with legislation
trade unions	to take an active part in the decision-making process

Example of stakeholder management

R is a high-class hotel situated in a thriving city. It is part of a worldwide hotel group owned by a large number of shareholders. Individuals hold the majority of shares, each holding a small number, and financial institutions hold the rest. The hotel provides full amenities, including a heated swimming pool, as well as the normal facilities of bars, restaurants and good quality accommodation. There are many other hotels in the city, all of which compete with R. The city in which R is situated is old and attracts many foreign visitors, especially in the summer season

The main stakeholders with whom relationships need to be established and maintained by management and the importance of maintaining these relationships is as follows.

Internal stakeholders

The employees and the managers of the hotel are the main link with the guests and the service they provide is vital to the quality of the hotel as guests' experience at the hotel will be determined by their attitude and approach.

Managers should ensure that employees deliver the highest level of service and are well trained and committed.

Connected stakeholders

The shareholders of the hotel will be concerned with a steady flow of income, possible capital growth and continuation of the business. Relationships should be developed and maintained with the shareholders, especially those operating on behalf of institutions. Management must try to achieve improvements in their returns by ensuring that customers are satisfied and are willing to return.

Each guest will seek good service and satisfaction. Different types of guests, for example business versus tourist, will have different needs and managers should regularly analyse the customer database to ensure that these needs are met.

Suppliers should be selected very carefully to ensure that services and goods provided (for example, food and laundry) continue to add to the quality of the hotel and to customer satisfaction. Suppliers will be concerned with being paid promptly for goods. Maintaining a good relationship with suppliers will ensure their continued support of the hotel.

External stakeholders

The management of the hotel must maintain close relationships with the authorities to ensure they comply with legislation. Examples of external stakeholders include fire and safety authorities and food hygiene authorities. Failure to do so could result in the hotel being closed down.

Stakeholder conflict

The needs/expectations of the different stakeholder groups may conflict. Some of the typical conflicts are shown below:

Stakeholders	**Conflict**
Employees versus managers	Jobs/wages versus bonus
Customers versus shareholders	Product quality/service levels versus profits/dividends
General public versus shareholders	Effect on the environment versus profit/dividends
Managers versus shareholders	Independence versus growth by merger/takeover

It is important that an organisation meets the needs of the most dominant stakeholders, but the needs of the other stakeholders should also be considered – nearly every decision becomes a compromise. For example, the firm will have to earn a satisfactory return for its shareholders whilst paying reasonable wages.

Now that we understand what we mean by ‘stakeholders’ we can introduce the concept of ‘corporate social responsibility’.

Corporate social responsibility (CSR) refers to the idea that a company should be sensitive to the needs and wants of all the stakeholders in its business operations, not just the shareholders.

As such, business ethics are just one dimension of CSR.

A socially responsible company may consider:

- the environmental impact of production or consumption, for example due to the use of non-renewable resources or non-recyclable inputs
- the health impact for consumers of certain products, for example tobacco and alcohol
- the fair treatment of employees
- whether it is right to experiment on animals
- the safety of products and production processes.

Traditionalists argue that companies should operate solely to make money for shareholders and that it is not a company’s role to worry about social responsibilities.

The **modern view** is that by aligning the company's core values with the values of society, the company can improve its reputation and ensure it has a long-term future due to the following:

- **Differentiation** – the firm's CSR strategy (for example with regards to the environment, experimentation on animals or to product safety) can act as a method of differentiation.
- **High calibre staff** will be attracted and retained due to the firm's CSR policies.
- **Brand strengthening** – due to the firm's honest approach.
- **Lower costs** – can be achieved in a number of ways, for example due to the use of less packaging or energy.
- The identification of **new market opportunities** and of **changing social expectations**.

An overall **increase in profitability** should be achieved as a result of the above – good CSR should hopefully contribute to an increase in revenue and a reduction in costs in the long-term.

e.g

Illustration 4 – Responsibilities of businesses to stakeholders

888.com is an internet gambling site that is listed on the London Stock Exchange. Its headquarters are in Gibraltar and it operates under a licence granted by the Government of Gibraltar.

It has responsibilities to the following stakeholders:

- **Shareholders** – since it is listed on the London Stock Exchange it must comply with the rules of that exchange, including adopting the Corporate Governance Code (the code is discussed later in this chapter).
- **Employees** – to be a good employer to all its members of staff.
- **Customers** – to offer a fair, regulated and secure environment in which to gamble.
- **Government** – to comply with the terms of its licence granted in Gibraltar.
- **The public** – the company chooses to sponsor several sports teams as part of strengthening its brand. The company also tries to address public concerns about the negative aspects of gambling, for example by identifying compulsive gamblers on their site and taking appropriate action.

Test your understanding 4
Voluntarily turning away business
Why should a gambling company like 888.com voluntarily choose to turn away certain business, for example known compulsive gamblers, gamblers who may be under-age, gamblers in certain countries etc?

Test your understanding 5
Humes plc adopts a socially responsible approach.
This means that the company seeks to:
A Meet the minimum obligations it owes to its shareholders
B Exceed the minimum obligations it owes to its shareholders
C Meet the minimum obligations it owes to its stakeholders
D Exceed the minimum obligations it owes to its stakeholders

5 Corporate governance

The discussion of corporate governance touches upon and builds upon aspects of business ethics and CSR.

5.1 Why corporate governance?

Corporate governance has become a major business issue driven by a succession of public ‘scandals’.

In the early nineties, the collapse of London Stock Exchange listed company Polly Peck International, the Mirror Group collapse (and the associated Maxwell pension scandal) and the liquidation of BCCI (The Bank of Credit and Commerce International) led to the formation of the **UK Corporate Governance Code**.

Illustration 5 – Why corporate governance?

Polly Peck International

Asil Nadir, the owner of Polly Peck International (PPI) built the company from very little but by the end of the 1980s it was worth over £2bn. However, the company collapsed in 1991 following the discovery of huge theft by Nadir from his own company, totalling £29m.

The Mirror Group

In 1991 the Mirror Group collapsed amid allegations that £440m had been defrauded from the company's pension scheme by its owner, the late Robert Maxwell. An enquiry concluded that Robert Maxwell and his son Kevin had a heavy responsibility for the collapse of the company but that City Institutions were also to blame.

BCCI

In 1991 BCCI was forced to shut its doors by the Bank of England amid identification of huge fraud. Hard hit were 35 local UK councils who lost approximately £90m in investments.

More recently, the 2008 financial crisis, which claimed Lehman Brothers, Northern Rock, Bradford & Bingley and many others, saw the code revised and radical changes to how risks are assessed within financial institutions.

The **need for corporate governance** arises because, in all but the smallest of organisations, there is a separation of ownership and control.

The **separation of ownership and control** refers to the situation in a company where the people who own the company (the shareholders) may not be the same people as those who run the company (the board of directors).

This separation can bring benefits (for example, specialist managers can often run the company more efficiently than those who own the company). However, there is a risk that the directors may run the company in their own interests, rather than those of the shareholders and the other stakeholders. This is referred to as the '**agency problem**'.

Illustration 6 – The agency problem in a company

The directors of a large quoted company may hold a board meeting and vote themselves huge bonuses and salaries even if only modest profit targets are achieved and may also put contractual terms in place granting them huge compensation payments if they are sacked. Those votes are in the selfish best interests of the directors, and not in the best interests of the shareholders who own the company and whose interests the directors are meant to be looking after.

5.2 The meaning of corporate governance

Corporate governance is the set of processes and policies by which a company is directed, administered and controlled. It includes the appropriate role of the board of directors and the auditors of the company.

Corporate governance is concerned with the overall control and direction of a business so that the business's objectives are achieved in an acceptable manner by **ALL** stakeholders.

The following **symptoms** can indicate that there is poor corporate governance:

- **Domination of the board** by a single individual or group
- **No involvement by the board, for example** meeting irregularly, failing to consider systematically the organisation's activities and risks, or basing decisions on inadequate information
- **An inadequate control function**, for instance no internal audit, or a lack of adequate technical knowledge in key roles, or a rapid turnover of staff involved in accounting and control
- Lack of **supervision** of employees
- Lack of independent scrutiny by **external or internal auditors**
- Lack of **contact with shareholders**
- Emphasis on **short-term profitability**, leading to concealment of problems or errors, or manipulation of financial statements to achieve desired results
- **Misleading financial statements and information**

5.3 The principles of corporate governance

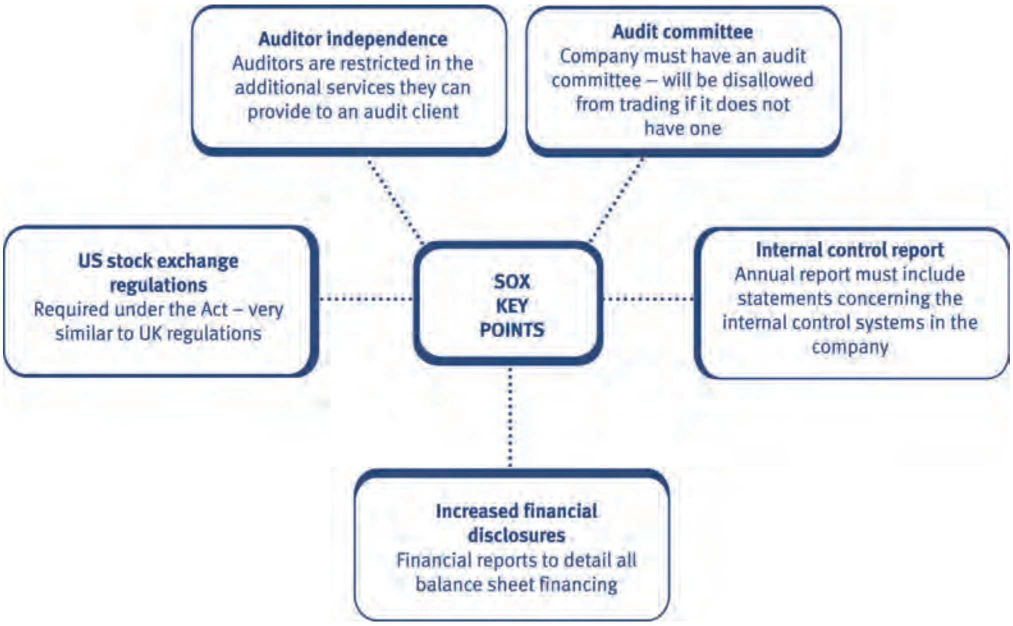
One of the main debates surrounding corporate governance regulation is whether it should be:

- A set of **best practice** guidelines – as in the UK with its principles based approach requiring companies to adhere to the spirit rather than the letter of the law.
- A **legal** requirement – as in the US with appropriate penalties for transgression.

The US Sarbanes-Oxley Act 2002 (SOX)

In 2002, following a number of corporate governance scandals such as Enron and WorldCom, tough new corporate governance regulations were introduced in the US by SOX.

SOX is only applicable in the US and for subsidiaries of US-based companies.



5.4 Features of the UK corporate governance code

In the UK, company law sets out a great many of the rules on corporate governance, especially with regards to the following:

- The **board of directors**
- **Directors' powers and duties**
- The **relationship of the company with directors**, such as loans to directors and the interests of directors in company contracts
- Accountability for stewardship and financial reporting via the **financial statements**
- Rules on meetings and resolutions

The Financial Reporting Council (FRC) is the body responsible for promoting high standards of corporate governance in the UK. All companies listed on the London Stock Exchange are required to apply the principles of the **UK Corporate Governance Code** (last revised in 2018) and must produce a disclosure statement confirming compliance with the code and explaining any departures from it.

Smaller listed companies, i.e. those not in the FTSE 350 can take a more flexible approach to applying the code. (**Note:** The FTSE 350 is an index of the top 350 companies by capitalisation and includes the more commonly used FTSE 100 index, which contains the top 100 companies and the smaller FTSE 250 combined.)

The following guidance exists:

Use of the AGM

The board should use the annual general meeting (AGM) to construct a dialogue with shareholders.

Board

The company should have an effective board (with a balance of skills, experience, independence and knowledge) that meets regularly. The annual report should identify the Chairman, Deputy Chairman, Chief Executive Officer (CEO), senior independent directors and the members and chairs of the board committees. It should also disclose the number of meetings held and the directors' attendance.

The revised 2018 Code emphasises the importance of positive relationships between the company, its shareholders and its stakeholders. For example, the board is now responsible for workforce policies and practices that reinforce a healthy culture.

Chairman and Chief Executive Officer (CEO)

The positions of the Chairman (person responsible for leadership and board effectiveness) and the CEO (the person in charge of running the company) should be separated. This is to ensure that no one individual has too much power within the company. The Chairman should be independent on appointment.

Non-executive directors (NEDs)

Directors who are involved in the execution of day-to-day management decisions are called **executive directors (EDs)**. Those who primarily only attend board meetings (and the meetings of board committees) are known as **NEDs.**

Current guidance is that NEDs should as far as possible be 'independent' so that their oversight role can be effectively and responsibly carried out. NEDs must not:

- have been an employee of the company in the last five years
- have had a material business interest in the company for the last three years either directly or indirectly (for example, as an employee of an organisation that has a relationship with the business)
- participate in the company's share options, performance-related pay scheme or pension schemes
- have close family ties with company directors or senior employees

- serve as a NED for more than nine years with the same company
- hold cross directorship (i.e. two or more directors sit on the board of the same third party company) or have significant links with other directors through involvement in other organisations.

If any of these apply to a NED, their independence will be seriously compromised.

Typical recommendations include:

- At least half of the board (excluding the chairman) should comprise independent NEDs. A smaller company should have at least two independent NEDs.
- One of the NEDs should be appointed the 'senior independent director'. Shareholders can contact them if they wish to raise matters outside the normal executive channels of communication.

Test your understanding 6

Independent NED

Mr X retires from the post of finance director at AB plc. The company is keen to retain his experience, so invite him to become a NED of the company.

Can he qualify as an independent non-executive?

Nomination committees

Appointments to the board should be made via a nominations committee. Over 50% of this committee should be made up of NEDs. This is to provide some independence from the current board members and to ensure that all appointments are based on merit and suitability and that the composition of the board is balanced.

The revised 2018 Code states that the committee is responsible for effective succession planning when developing a more diverse board and that the gender balance of senior management and their direct reports should be reported.

Remuneration committees

It is an important principle of corporate governance that no director should be involved in setting the level of their own remuneration.

A remuneration committee is a committee made up of NEDs (at least three for FTSE 350 companies and at least two for smaller listed companies) which is responsible for deciding on the pay and incentives offered to executive directors (including pension rights and compensation payments). The Chairman can be a member but cannot chair the committee. The chair must have been a committee member for at least 12 months.

Remuneration should be sufficient to attract, retain and motivate quality directors but shouldn't be more than necessary. A significant proportion of director's pay should be performance related.

The revised 2018 Code states that there should be clear reporting on remuneration and how its helps the organisation to achieve its strategy and long-term success and its alignment to workforce remuneration.

Remuneration committee

Advantages of having a remuneration committee:

- It avoids the agency problem of directors determining their own levels of remuneration.
- It leaves the board free to make strategic decision about the future.

Disadvantages of having a remuneration committee:

- There is a danger that NEDs may recommend high remuneration for the executive directors in the hope that the executives will recommend high remuneration for the NEDs.
- There will be a cost involved in preparing for and holding the meetings

Test your understanding 7

Remuneration of NEDs

On what basis should NEDs be remunerated for their service to the company?

Test your understanding 8

Which one of the following can non-executive directors accept as remuneration from the company?

A A fixed daily rate for their time

B Shares

C Pension payments

D Equity options

Audit committees

An audit committee consists solely of independent NEDs (at least three for FTSE 350 companies and at least two for smaller listed companies) who are responsible for monitoring and reviewing the company's financial controls and the integrity of the financial statements.

The board should review the effectiveness of risk management and internal controls at least annually and report to shareholders covering all material controls.

The audit committee acts as an interface between the board of directors on one side and the internal and external auditors on the other side. They:

- review the work and effectiveness of the internal audit function
- monitor the external auditor's independence and objectivity
- short-list external audit firms when a change is needed.

An audit committee should be the first point of contact for auditors, improving the independence and the overall quality of the audit functions.

The role of the audit committee

Responsibilities include the following:

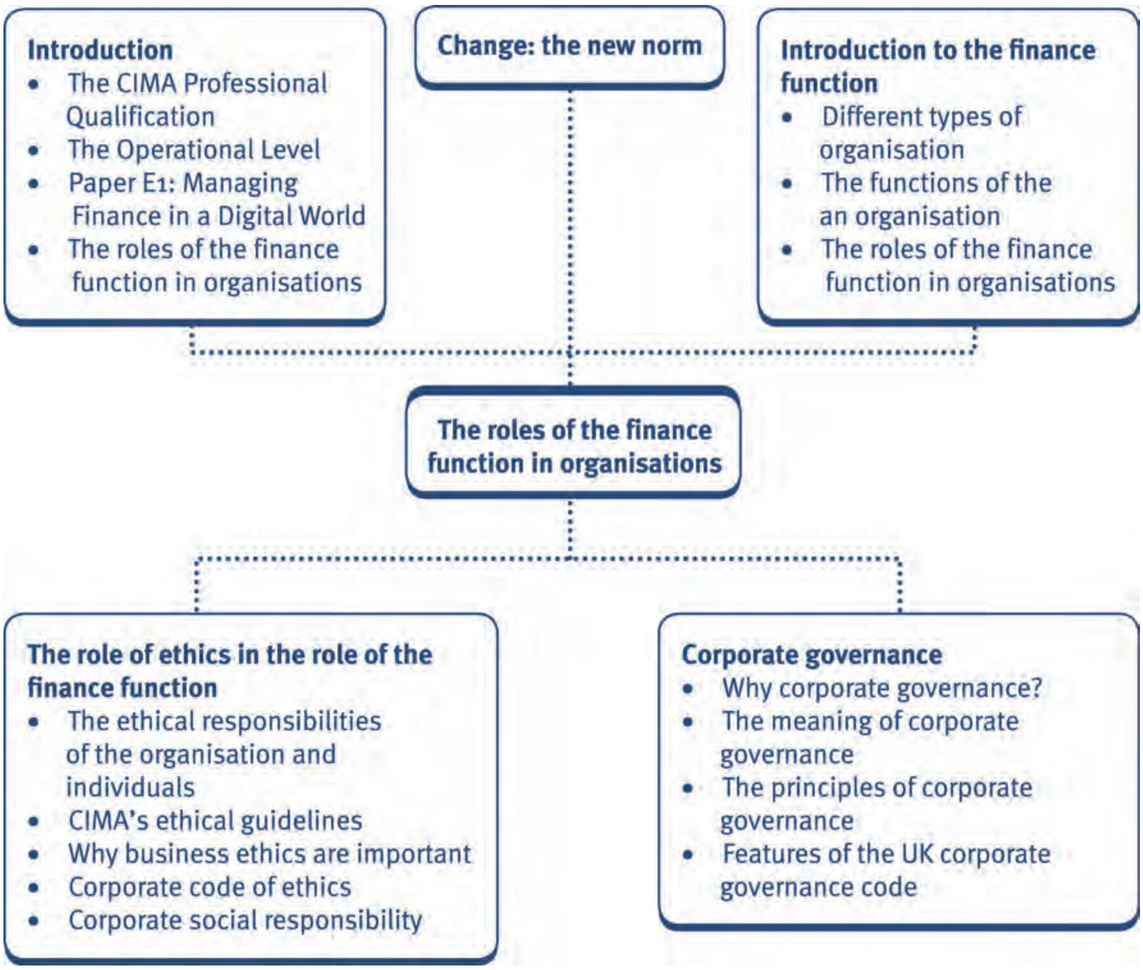
- Reviewing accounting policies and financial statements as a whole to ensure that they are appropriate and balanced.
- Review systems of internal controls and risk management within the organisation. (Note that risk management may be dealt with by a separate committee – the risk committee.)
- Agreement of the work agenda for the internal audit department, as well as reviewing the results of internal audit work.
- Liaising with the external auditors, including dealing with problems in the audit as they arise as well as the appointment and removal of external auditors.

Test your understanding 9

Composition of audit committee

Why are the members of an audit committee required to be NEDs rather than executive directors?

6 Chapter summary



Test your understanding answers

Test your understanding 1
The correct answers are: **B** – Medical research charity **C** – Local hospital **F** – Local government agency

Test your understanding 2
The correct answer is **B** By virtue of his family relationship John's objectivity is potentially compromised. There is also an argument that answer A (integrity) and answer E (professional behaviour) are also correct. Do note that this question is in the Study Text to get you to start thinking about these principles. Any questions given in the exam will have a definitive right or wrong answer.

Test your understanding 3
The correct answers are **A, B, C, D and E** All of the issues would be of ethical concern.

Test your understanding 4
Either you could argue that such action was ethically correct (with the company wanting to 'do the right thing'), or you could argue that a concentration on short-term profits is likely to store up problems in the longer term. If under-age gamblers are seen to be gambling on a particular website, then the public reputation of that site will be damaged and its long term profitability could be in jeopardy if governments or customers turn against it.

Test your understanding 5
The correct answer is **D** A socially responsible organisation seeks to exceed their obligations they owe to all stakeholders not just the shareholders.

Test your understanding 6

It is very unlikely that Mr X can be independent since he has been an employee of the company within the last five years. If the board believes that Mr X is independent despite his recent employment then they must state the reasons for this determination.

Test your understanding 7

NEDs should be paid fees that reflect the time commitment and the responsibilities of the role, for example a fixed daily rate for when they work for the company. Share options should not be granted to the NEDs since this could detract from their independent judgement.

Test your understanding 8 – OTQ

The correct answer is **A**

NEDs should be paid fees that reflect the time commitment and the responsibilities of the role, for example a fixed daily rate for when they work for the company. Share options should not be granted to NEDs since this would detract from the detached judgement that they should bring, and it would also prevent them from being identified as 'independent' NEDs.

Test your understanding 9

NEDs have no day-to-day operating responsibilities, so they are able to view the company's affairs in a detached and independent way and liaise effectively between the main board and both sets of auditors.