Corporate Governance

FIFTH EDITION

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2019

First published June 2002
Second Edition March 2005
Third Edition May 2010
Fourth Edition 2015
Fifth Edition 2019

by

Siber Ink CC
PO Box 30702
Tokai 7966
Cape Town
SOUTH AFRICA

www.siberink.co.za

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ISBN (print format) 978-1-928309-22-2
ISBN (pdf format) 978-1-928309-23-9
ISBN (epub format) 978-1-928309-24-6
ISBN (mobi format) 978-1-928309-25-3

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Cover design by
Nic Jooste, Comet Design

Set in 9½ on 13 pt Stone Serif by
G J du Toit, Cape Town

Printed and bound by
Tandym Print, Cape Town

Foreword to the First Edition

It is hard to imagine a more relevant and appropriate business book than this one on corporate governance. Corporate governance failures both locally and internationally have filled the media and have negatively impacted on the confidence in the free market system.

If South African companies are to compete for international capital and if much needed jobs are to be created through increased direct foreign investment, behaviour in our boardrooms must be beyond reproach. South African companies and the public sector must set the highest standards whilst remaining strongly competitive.

The publication of this book by Tom Wixley and Geoff Everingham so soon after the publication of the 2002 King Report (King II) is to be welcomed. It will act as a useful guide for captains of industry and the public sector, for budding entrepreneurs and students alike. Applying the knowledge and guidance provided by the authors will significantly increase confidence in the South African markets.

ROY ANDERSEN

Chairman of Sanlam Ltd and of Murray and Roberts Holdings Ltd
Member of the King Committee on Corporate Governance
Formerly Deputy Chairman and Group Chief Executive, Liberty Group Ltd
Formerly President of the Johannesburg Stock Exchange

Johannesburg, May 2002

Preface to the Fifth Edition

This edition follows fairly soon after the publication of the fourth edition in 2015. However, that preceded the King IV report, so this edition contains commentary on the new King Code as well as developments in governance theory and practice.

In particular, shocking revelations and corporate collapses, both locally and globally, require a fresh look at what makes for good corporate governance—in both the private and public sectors. Any complacency which may have crept into corporate governance practices has been swept away, and directors need to be more alert than ever as to their responsibilities and their exposure, both reputationally and in law.

This edition introduces a third author, Karen Louw, a qualified lawyer, who brings a fresh perspective on the issues facing those charged with governance.

As in the past, we have updated illustrations where appropriate—and we express our thanks to the Institute of Directors for permitting us to make liberal use of the King IV Report and related documentation.

TOM WIXLEY, GEOFF EVERINGHAM AND KAREN LOUW
November 2018

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To assist readers, when referring to the King IV Code™, we have provided in brackets the page number, the number of the Principle and the number of the Recommended Practice. Thus, for example, (43; 1; 1.a.i.) refers to the Recommended Practice 1.a.i ('Members must act in good faith and in the best interest of the organisation') of Principle 1, on page 43 of the King Report.

The King IV Code is intended to provide governance guidance to different types of organisations. The Principles in the Code therefore use generic terminology (such as 'governing body' and 'member'). This book is primarily focused on the governance of 'for profit' companies. For the sake of expediency we will therefore use corporate-specific terminology (such as 'board' and 'shareholders'), interchangeably for the generic King IV terminology.

CHAPTER 1

Why Corporate Governance?

If management is about running the business, governance is about seeing that it is run properly …

R I Tricker, 1984

1. Background

Corporate governance has been described as 'simply the system by which companies are directed and controlled'.[1] More specifically, it is concerned with the structures and processes associated with management, decision-making and control in organisations.

While corporate governance, as a separate topic, has become prominent only relatively recently, dating back to the last decade of the 20th century, the origins of corporate governance go back to the time when ownership and management of enterprises were first separated. This meant that owners needed mechanisms to monitor the performance of managers. The concept of stewardship, and the role of the auditor as someone who would check that proper stewardship had taken place, emerged from this separation of ownership and management.

Until the Industrial Revolution, businesses tended to have only one active owner or a small number of active owners. Businesses often represented one-off trading ventures, rather than enterprises with continuity.

The Industrial Revolution brought about a need for large amounts of capital to be raised and led to the emergence of 'incorporated' enterprises. These had the advantage of being distinct from their owners, thus permitting a large number of shareholders (in the case of companies) and enabling interests in the enterprise to be bought and sold without affecting its ongoing continuity. Having a large number of owners also made it possible for enterprises to raise considerable sums of capital. These arrangements were obviously much more complex than those of the one-off trading ventures of the past, and this led to some form of regulation and control so as to protect the interests of the owners.

At first, corporate governance arrangements were embodied in company legislation and common law,[2] but little else. Thus, Companies Acts in South Africa and elsewhere would deal with matters such as the appointment of directors, the operations of boards of directors, the role of auditors and the like. While an extensive academic literature evolved, dealing, for example, with the principal–agent relationship, there were few developments in practice, until events caused changes to take place in the 1990s (see paragraph 3 below).

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[1] King 1994: 1.

[2] The part of South African law that is derived from custom and judicial precedent, rather than statutes.

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Corporate governance is now a major concern in business. This book explores the practicalities of corporate governance. We take particular cognisance of the King IV[3] Report, the Companies Act[4] and the requirements of the Johannesburg Stock Exchange (the JSE).

The four 'King' reports[5] on corporate governance have had a profound influence on the prominence of and approach to corporate governance in South Africa. Part 5 of the King IV Report (the King IV 'Code') contains specific Principles and Recommended Practices which provide detailed guidance to businesses on the implementation of governance. (The predecessor of King IV was the *King Report on Corporate Governance for South Africa, 2009,* which we shall refer to as King III[6]).

Before exploring specific corporate governance-related topics, it is useful to have some idea as to the nature of corporate governance and the issues which gave rise to its emergence.

2. The nature of corporate governance

Broadly speaking, key elements of governance are (according to R I Tricker[7]) (i) supervising or monitoring management performance, and (ii) ensuring accountability of management to shareholders and other stakeholders.

King IV builds on the above themes. It defines corporate governance as the exercise of ethical and effective leadership by the board, towards the achievement of the following governance outcomes (i) ethical culture (ii) good performance (iii) effective control and (iv) legitimacy.

2.1 View on stakeholders determines approach to governance

The reference by Tricker to 'other stakeholders' makes the important point that the role of the corporation in society has evolved from one where their responsibilities were seen as being exclusively to shareholders, to one where the role of other stakeholders, such as employees and suppliers, is acknowledged. Furthermore, many corporations are of such size that their influence pervades society as a whole and the general public can be regarded as a stakeholder. The state itself is usually an important stakeholder in its role as tax gatherer and, in some sectors, as regulator.

There is a fundamental debate as to the relationship between the company and its stakeholders and the extent of a company's responsibilities to stakeholders.

---

[3] The King IV Report on Corporate Governance for South Africa, 2016.

[4] Companies Act No 71 of 2008.

[5] The so-called 'King' reports were written by the King committee on Corporate Governance in South Africa, chaired by Mervyn King SC. The 'King IV Report' is the fourth report on corporate governance published by this committee.

[6] Reports were issued by the King committee in 1994 (King I), 2002 (King II) and 2009 (King III). The fourth revision was issued in 2016. The Institute of Directors of Southern Africa owns the copyright in respect of these reports. Copyright and trade marks are owned by the Institute of Directors in Southern Africa NPC and all of its rights are reserved.

[7] Author of Corporate Governance, Gower 1984.

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Depending on the standpoint in this regard, the manner in which corporate governance is approached will differ.

Traditionally, the view taken is that the company exists in order to maximise shareholder wealth; the interests of other parties such as employees, and society in general, are subsidiary to this objective. Governance would therefore disregard the interests of such parties except insofar as this was necessary to further the interests of shareholders. A justification for this view is that entrepreneurs and their backers create economic activity and growth to the benefit of society and deserve to be rewarded for the risks they take.

At the other extreme is a view that holds that the company exists to serve the interests of all parties with which it engages, implying that profit maximisation should not be the main objective, and possibly not an objective at all. Governance would need to take account of the interests of all parties, on an equal basis. It is suggested that this approach (sometimes termed a 'pluralist' view) is simply not practicable, and does not allow for the differing level of investment which the various parties have made in the company.[8] In addition, the authors propose that such an approach to governance is not likely to contribute to the creation of sustainable companies.

The King IV Code proposes a 'stakeholder inclusive approach' (Principle 16) which requires that the board does take account of the legitimate and reasonable needs, interests and expectations of all material stakeholders in the execution of its duties, but, with the very important qualification, that this must be done with a view to the best interest of the company over time.

2.2 Responsibility for governance in an organisation

It must be emphasised that 'governance' (as envisaged in King IV and this book) relates to the governing of an organisation at the top. Although governance generally requires detailed tasks to be carried out at a lower level in the organisation (such as application of control systems), governance focuses on what happens — or does not happen — at the level of the board and top management. It necessarily concentrates on the activities of those carrying ultimate responsibility for the success or failure of the organisation.

2.2.1 Definition of corporate governance

King IV defines governance with respect to what it aims to achieve. As indicated in paragraph 2 above, governance is defined as:[9]

> 'The exercise of *ethical* and *effective leadership* by the board towards the achievement of the following *governance outcomes*:
> (i) ethical culture
> (ii) good performance
> (iii) effective control
> (iv) legitimacy'

[8] The pluralist approach is more appropriate in respect of not-for-profit organisations, where donors typically do not have the expectation of a financial return on their funds.

[9] King IV Report (20).

King IV refines the description of *ethical leadership* as involving the anticipation and prevention, or otherwise amelioration, of the negative consequences of the organisation's activities and outputs on the economy, society and the environment and that it is exemplified by (i) integrity, (ii) competence, (iii) responsibility, (iv) accountability, (v) fairness and (vi) transparency.[10]

Effective leadership is described as being results-driven and is about achieving strategic objectives and positive outcomes. Effective leadership includes, but goes beyond, an internal focus on effective and efficient execution.

Ethical and effective leadership should complement and reinforce each other.

2.2.2 Primary governance role and responsibilities of the board

King IV indicates that the *primary governance role and responsibilities of the board* will be to:

(i) steer and set strategic direction with regards to:
  (*a*) the company's overall strategy,
  (*b*) the manner in which specific governance areas are approached;
(ii) approve policy and planning that gives effect to the strategy;
(iii) oversee and monitor implementation and execution by management;
(iv) ensure accountability for performance, by among others, reporting and disclosure.

The Recommended Practices in the Code provide detailed guidance on each of the above, to illustrate how the above activities will be exercised in the context of each Principle.

2.3 Organisation of this book

We address important components of governance in more detail in individual chapters of this book.

The issue of strategic direction is covered in chapter 4. Executive action and its supervision will be dependent on the composition of the board of directors (chapter 5) and the behaviour of individual directors (chapter 6) and by how well the board functions (chapter 7). The functioning of the board is facilitated by the use of various board committees (chapter 8) and by proper assessment of risk and the maintenance of sound internal controls (chapter 9).

Matters of accountability involve the presentation of financial information (chapter 12) and the steps taken to ensure reliability of the information via external audit (chapter 15) and internal audit (chapter 16). In recent years increasing emphasis has been placed on non-financial information (chapter 13) and the governance of remuneration (chapter 18).

Finally, corporate governance is not confined to the private sector; it is also relevant to the public sector (chapter 19) and smaller enterprises (chapter 20).

[10] Recommended Practices relating to these concepts are all addressed under Principle 1 of the King IV Code.

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3. Governance structures

Good governance can be achieved by means of a variety of governance 'models'.

3.1 Unitary board

The classical governance model, often referred to as the Anglo-Saxon model, derives from the first UK Companies Act of 1844, which enshrined the concept of the company as a legal entity separate from its owners.

Governance was to be achieved by a single board of directors appointed by the members and reporting to them on the stewardship of the enterprise. The shareholders would appoint independent auditors to report on the fairness of presentation of the financial statements.

The practice evolved of appointing full-time executive directors (typically a managing director, or chief executive officer), as well as having a number of non-executive directors. Interestingly, in law there is no distinction between the duties and responsibilities of executive and non-executive[11] directors. The courts do recognise that the level of knowledge and responsibility is affected by the different roles of executive and non-executive directors. However, whether the board has executive directors, non-executive directors, or both, it functions as a single unit.

3.2 Two-tier system

On the continent of Europe, different patterns of corporate governance developed, perhaps best illustrated by the system in Germany. In Germany, the law requires some companies to have two boards of directors:

- a supervisory board, with no executive power, but with the authority to appoint, approve or remove members of the management board and which must approve major business decisions. Half of the members of the supervisory board are elected by shareholders and the other half are employee representatives;
- a management board, responsible for the ongoing management of the enterprise and with the responsibility of reporting to the supervisory board at regular intervals.

The German model is based on 'co-determination' (*Mitbestimmung*) and requires that companies (other than certain industries which have different arrangements) with more than 2000 employees have a supervisory board with equal representation of employee and shareholder representatives; and where there are between

[11] The South African Companies Act does not use the terms 'executive' and 'non-executive' directors; it merely refers to 'directors'. This distinction is given some legal standing by the JSE Listings Requirements, which require listed companies to categorise directors as executive or non-executives in accordance with the following definitions in the Listings Requirements (s 3.83(*e*)):
executive directors: are directors that are involved in the management of the company and/or in full-time salaried employment of the company and/or any of its subsidiaries
non-executive directors: are directors that are not (1) involved in the day to day management of the business, or (2) full-time salaried employees of the company and/or any of its subsidiaries.

501 and 2000 employees, employee representatives must make up a third of the board. The chairman, typically a shareholder representative, has a casting vote, leaving effective control with the shareholders; nevertheless, the German system has created a climate in which disputes are more likely to be settled by dialogue rather than through conflict. However, there is also criticism of this system, which arguably leads to less than ideal oversight and is costly to implement.

There has been some debate about whether the two-tiered system in the Netherlands has contributed to the much-publicised failure of Steinhoff International.

The following article was published in[12] The Conversation on 28 January 2018:

'Did Steinhoff's board structure contribute to the scandal?

The global retail group Steinhoff is reeling under allegations of accounting fraud. Since the allegations surfaced last year the CEO of the multi-billion dollar business, Markus Jooste, has fallen on his sword and the company's stock has been hammered, at one point losing about 90% in market value in a few days.

Observers are calling for harsh punishment, including jail, for the culprits.

Early reports suggest that Steinhoff was involved in massive accounting fraud, including the overstatement of the company's financial position.

The company is listed on both the Johannesburg Stock Exchange in South Africa as well as the Frankfurt Stock Exchange in Germany. With a primary listing in Frankfurt and an Amsterdam corporate address, Steinhoff follows the Dutch corporate governance code.

Consistent with this code, Steinhoff has a two-tier board structure. This is made up of a management board (comprised of four top executives) and a supervisory board (comprised of 9 non-executive directors).

The point of the two-tier board structure is to ensure that the supervisory board is independent from the executives who sit on the management board. The management board accounts to the supervisory board, which accounts to the shareholders or to the company.

The two-tier board structure is favoured in Western Europe. The US and UK prefer the one-tier — or unitary board — structure, as does South Africa for historical reasons.

It appears that Steinhoff's decision to opt for the two-tier board structure may have contributed to its undoing. Natural holes in the structure, the biggest one being the fact that the management board doesn't always keep the supervisory board in the loop, combined with Steinhoff's corporate culture which was anchored by a dominant personality, appear to have created accountability holes.

Two-tier versus one-tier structure

There are pros and cons to both systems.

One of the good things about the one-tier board system is that executive directors and non-executive directors sit together on a single board. Traditionally there

[12] https://theconversation.com/did-steinhoffs-board-structure-contribute-to-the-scandal-89704.

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would be two or three executive directors (the CEO, chief financial officer and the chief operating officer) sitting alongside a majority of non-executive directors.

This means that there's a seamless flow of information between executives and non-executives. The executives can be asked questions with the entire board present. This closes any information asymmetry. In addition, it can also facilitate quicker decisions.

On the downside, the unitary board structure has been criticised for its propensity to compromise the independence of the non-executive directors. This dilutes their oversight role.

For its part the two-tier system seems to have more checks and balances built into it given that the management board is subject to oversight by the supervisory board, and the supervisory board has to answer to shareholders.

But the two-tier structure is often criticised for information asymmetry between the management board and the supervisory board. In other words management knows a great deal more about the business than the supervisory board. This can lead to operational challenges developing without the board noticing until it's too late.

Steinhoff's board structure followed the two-tier system. In 2016 its management board comprised three members, Jooste (CEO), Ben La Grange (Chief Financial Officer) and Danie van der Merwe (Chief Operating Officer and now acting CEO). As is normal under the two-tier system, none of the three members of the management board sat on the supervisory board.

Some analysis of the Volkswagen emissions scandal apportioned blame to the two-tier system combined with a corporate culture that was anchored by dominant personalities.

A similar case can be made for the Steinhoff saga.

Flaws in the Steinhoff structure

Did the two-tier structure give the CEO too much leeway to take decisions that in the end led to the near collapse of the company?

This may indeed have been the case. Take, for example, the fact that some believe the company grew too quickly.

The danger of companies expanding too rapidly was highlighted decades ago by author and corporate strategy guru John Argenti who came up with a model that considered factors leading to corporate failure. Two of the higher scored factors were expanding too fast (referred to as overtrading) and high levels of loan borrowing.

Steinhoff seems to have suffered from both. And yet the supervisory board appears to have failed to raise the red flag when it comes to large transactions. An example of it failing to fulfil its oversight role was when it decided to not make public Steinhoff's USD$1 billion transaction with a related company. Even if the supervisory board didn't legally have to make this public knowledge, ethically it should have made the disclosure.

The functioning of the audit and risk committee didn't help the situation either.

Audit and risk committee

Steinhoff had three standing committees of the supervisory board—audit and risk, human resources and remuneration and the nominations committee. The committee structure had two weaknesses.

The first was that too few of its non-executives actually served on the committees—only 5 of the 11 supervisory board members. And given that the then chairman Wiese and Claas Daun only sat on one, it begs the question how only three members of the supervisory board could have been expected to carry the real responsibility of the standing committees.

The second flaw was that audit and risk were wrapped up in one committee. This is the norm under a two-tier governance structure.

South Africa's corporate governance structures might have helped to address both these problems.

King IV stipulates that the risk governance committee should be made up of a mixture of non-executives and executives (the majority being non-executives). And the governance guidelines warn against audit and risk being under one committee. Its advice is that a company should only combine them if it's able to devote enough time to dealing with risk related issues.

For a company of Steinhoff's complexity, it seems inconceivable that the audit and risk committee could have devoted the necessary time to undertake its responsibility.

Conclusion

The Steinhoff case highlights weaknesses in the governance structure the company had chosen to operate under. That said, the rules have worked perfectly well for thousands of other companies. The lesson therefore is be alert to the warning signs such as dominant directors who don't heed the rules. They can pose a grave risk to any company.'

Owen Skae, Associate Professor and Director of
Rhodes Business School, Rhodes University

3.3 South African unitary board system

The 2002 King Report recommended that the unitary board structure 'remains appropriate for South African companies, given the positive interaction and diversity of views that takes place between individuals with different skills, experience and background'.[13] This view appears to have been accepted in King III and IV without debate. With respect, there is no reason why this 'positive interaction and diversity of views' should not apply equally in the case of a two-tier structure. It would, however, entail a major change in the structure of South African company law and corporate governance, so it is unlikely that any change will take place in the foreseeable future.

[13] King II, page 21.

4. The need to strengthen corporate governance

A number of events in the 1980s and early 1990s, both in South Africa and abroad, pointed to serious deficiencies in the Anglo-Saxon model of governance, as implemented in practice. Keasey & Wright, two UK academics, have identified the following concerns:

- the spread of creative accounting;
- spectacular increases in unexpected business failures;
- the apparent ease with which unscrupulous directors could expropriate other stakeholders' funds;
- the very limited role of auditors;
- the apparently weak link between executive compensation and company performance;
- a marketplace focused on short-term perspectives, to the detriment of general economic performance.

The introduction to the 1994 King Report put this slightly differently in identifying significant corporate failures arising from fraud, such as the Maxwell and BCCI scandals in the UK, and a perception that British and American companies were lagging behind in global competitiveness (from which the inference was drawn that there must be something defective in the functioning of corporate governance).

Whatever the reasons, it was the Cadbury report (which appeared in the United Kingdom in 1992, and in its updated form is now known as the UK Corporate Governance Code) which gave impetus to improved standards of corporate governance in the United Kingdom.

South Africa, too, had had its corporate scandals and, in the mid 1990s, was emerging from a legacy of secrecy which had built up from many years under the apartheid government, when international ostracism had led to devious and secretive business practices.

Despite the heightened focus on corporate governance in South Africa, assisted by the King reports and the introduction of numerous pieces of legislation to address the problems listed above (such as the adoption of International Financial Reporting Standards, the Auditing Profession Act of 2005 and the Companies Act of 2008) business failures (such as African Bank, Steinhoff and VBS Mutual Bank) have continued.

The dramatic collapses of global banks following the 2008 meltdown of markets also raised numerous questions about governance, in particular the need for directors to understand the complexities of what may be going on in their companies. These collapses have also raised doubts as to the efficacy of regulation. The third King report contains an interesting observation in this respect, with which the authors strongly concur (page 9):

> 'Critics of South Africa's light regulatory touch often suggest that emulation of the more "robust" US approach would improve corporate governance standards, and thereby reduce the risk of systemic economic crises in the future. However it is worth

> remembering that the US is the primary source of the current financial crisis. SOX [the Sarbanes-Oxley legislation] –with all of its statutory requirements for rigorous internal controls — has not prevented the collapse of many of the leading names in US banking and finance.'

Nor, one might add, did the Securities and Exchanges Commission prevent Bernard Madoff from robbing investors of billions of dollars in the greatest financial scam in history.

In a similar vein, King IV states (at p 35) that:

> 'In South Africa, as in many jurisdictions around the world, a hybrid system of corporate governance has developed as, over time, some practices of good governance have been legislated in parallel with the voluntary King codes of governance …
>
> There is an important argument against the mandatory "comply or else" framework: a one-size-fits-all approach cannot logically be suitable, because the types of businesses and activities carried out by organisations are so varied. There is also a danger that the governing body may become focused on mindless compliance instead of applying its mind to the best governance practice for the particular issue before it.
>
> Good corporate governance does not exist separately from the law, and a corporate governance code that applies on a voluntary basis may also trigger legal consequences.'

5. Risks and rewards

The very nature of business is to take risks in the expectation of rewards, commensurate with the risk taken. Inevitably this means that some enterprises will perform poorly, with the rewards not being commensurate with the risks and, in extreme cases, enterprises will fail.

Good corporate governance is not a guarantee against failure, but it should ensure that there is adequate disclosure of the risks undertaken and that, where enterprises do run into difficulties, these are handled with wisdom and integrity, in the best interests of the enterprise, and adequately communicated to stakeholders.

Like the United Kingdom, South Africa experienced numerous corporate failures in the early 1990s, examples being Sechold, Tollgate, Masterbond, IGI Insurance, Cape Investment Bank and Prima Bank. Such failures have continued in South Africa in the 2000s with cases such as Regal Treasury Private Bank (liquidated) and Unifer, a microlender which had to be rescued by its holding company, Absa Limited, at a cost of some R1.8bn.

What is particularly alarming is that several of these corporate collapses were financial institutions subject to external regulation — and that this continued into very recent times when African Bank collapsed in 2014 and VBS Mutual Bank in 2018. Clearly, the regulatory powers proved to be somewhat ineffectual in protecting the public (although, fortunately, African Bank did not take deposits from the general public). Possibly, good corporate governance by directors 'closer to the action' might have prevented some of the collapses which occurred.

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Below are some extracts from an Article published on Fin24[14]

Myburgh Report on African Bank delivers startling revelations

'…

Damning allegations

…

What was revealing about the Myburgh Report was the extent of corporate governance failures within ABIL and African Bank.

Leon Kirkinis's reported domination of the Board of ABIL and African Bank, the lack of seeming proper authority and disclosure around the purchase of Ellerines and the ongoing financial support provided by African Bank to the furniture retailer (at a time when African Bank itself was under severe financial strain), all point to multiple and significant corporate governance failures, despite ABIL's glossy integrated reports which purport to paint a picture of ABIL as a model corporate citizen.

The report is fairly scathing of the lack of required care and skill exercised by the directors of African Bank in approving the loans from the bank to Ellerines, and in fact concludes that the directors of the Bank Board acted "in breach of their fiduciary duty to the bank; did not act for the benefit of the bank and did not act in the best interests of the bank".

Questions also arise for us around the continued acceptance by ABIL's Board of the chief risk officer's position. The continued acceptance of the appointment (which lasted ten years) of a Chief Risk Officer who was, according to Myburgh, unqualified for the job — and reportedly incapacitated due to a severe drinking problem — is surprising.

Indeed, we are aware SARB was monitoring African Bank well before its failure, and we might question their acceptance of this continued appointment (even accepting that SARB is not responsible for the management of any of the South African banks that fall under their supervision).

What we can learn

The dust has yet to settle on this saga … While it is very difficult for any investor to know the detailed inner workings of a company, there are some telling signals that can be picked up from the annual financial statements (absent outright fraud which is harder to detect without a forensic audit).

Good analysis — including financial, operational, strategic, competitive, environmental, social and governance assessments — is key to uncovering what may really be happening in a company. Ongoing dissonance between what management says and the numbers are key flags in our analytical process at Futuregrowth and something we had identified as a problem from as early as 2012.

A healthy dose of cynicism and scepticism is needed by investors to see through the sometimes overly optimistic picture that management portrays. Proper risk

[14] https://www.fin24.com/Companies/Financial-Services/myburgh-report-on-african-bank-delivers-startling-revelations-20160530.

identification and analysis can uncover many of these inconsistencies which investors need to be aware of and ensure are properly priced into their investment decision-making.'

Article by Olga Constantatos on behalf of Futuregrowth
Published on Fin24 on 1 June 2016

Conversely, it is clear that good corporate governance does have its rewards. The 'Investor opinion Survey' by international consultants McKinsey & Company (June 2000) found that:

- More than 80% of more than 200 global institutional investors indicated willingness to pay a premium for shares in a well-governed company over one poorly governed, but with a comparable financial record.
- Three-quarters of these investors indicated that board practices were at least as important as financial performance in evaluating companies for potential investment.
- The premium these investors were prepared to pay varied from country to country — in the United Kingdom the investors would pay 18% more for the shares of a well-governed company, compared to one with similar financial performance, but poor governance. In emerging markets the premium escalated to as much as 27% for such a company in Venezuela or Indonesia.

These findings can only be understood in the context of what McKinsey's considered well-governed companies to be: Those where

- there was a clear majority of outsiders on the board, with no management ties;
- there were formal evaluations of directors;
- directors had significant stakes in the company and received a large proportion of their pay in the form of share options; and
- the companies were responsive to investor requests for information on governance issues.

A slightly more recent survey by McKinseys in 2002 (which regrettably appears not to have been conducted since) established that emerging market investors would pay a premium of between 20% and 40% for companies with strong boards — there has not been a more recent survey on this theme, but there is little reason to believe that this will have changed materially.

Much academic research has been conducted on the benefits of good corporate governance — one study demonstrated, inter alia, a clear correlation between good corporate governance and return on assets as well as share price performance.[15]

[15] Krafft, Qu, Quatraro and Revix, 'Corporate governance, value and performance of firms', University of Nice Sophia Antipolis, 2013.

The International Finance Corporation (World Bank Group) published the following in May 2017:[16]

- Over 10 years, well-governed companies across range of sectors saw superior valuation multiples of over 8% over their badly governed peers.
- Global Institutional Investors managing more than $1 trillion state that they will pay premium for well-governed companies.
- One standard-deviation improvement in corporate governance brings an improvement in valuation multiples that ranges from 18% for companies in major OECD markets to 33% in emerging markets.

The rest of this book focuses on the risks faced by businesses, and how good governance practices can assist in dealing with these risks. It covers the salient requirements of the King IV Code and seeks to demonstrate how these are a natural and integral part of good corporate governance, rather than a set of rules which enterprises are obliged to follow.

6. The King Reports

6.1 Background

The first King Report, a fairly tentative document compared to its successors, was published in 1994; the second King Report was made public in March 2002 and the third King report was released on 1 September 2009. King III was effective from 1 March 2010.

The fourth King Report was released on 1 November 2016 and became effective on 1 April 2017.

The 2002 King Report (King II) contained a Code of Corporate Practices and Conduct and, similarly, the 2009 Report (King III) was accompanied by a Code of Governance Principles. Implementation of these codes was voluntary, other than for entities where their governing legislation required application. Listed companies were obliged to apply and report on their application of the King Codes from 2005.

All listed companies are required to implement and report on implementation of the King IV Code in all reports published on or after 1 October 2017.[17]

6.2 Applicability of the King codes

6.2.1 Application of King II

The 2002 Code was written only for certain categories of business enterprises (referred to as 'affected companies'), in essence:

- companies listed on the JSE;
- banks, financial and insurance entities;

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[16] In a publication titled 'Corporate Governance: Investor Expectations and Typical Challenges https://www.supersociedades.gov.co/Historial%20de%20Noticias/2017/2-Davit%20Karapetyan.pdf.

[17] JSE Listings Requirements, s 8.63.

- public sector enterprises falling under the Public Finance Management Act and the Local Government Municipal Finance Management Act, including any state departments acting in terms of the Constitution or legislation.

6.2.2 Application of King III

From the publication of King III, it was envisaged that corporate governance would be applied by a wide range of organisations. King III stated (at p 17) that it applied 'to all entities regardless of the manner and form of incorporation or establishment and whether in the public, private sectors or non-profit sectors'. It also stated that its principles had been drafted so that every entity could apply them and, in so doing, achieve good governance.

However, subsequent experience proved that very few organisations, other than those that were obliged to apply it by legislation (being listed companies and state-owned enterprises falling under the Public Finance Management Act and the Local Government Municipal Finance Management Act, including any state departments acting in terms of the Constitution or legislation), applied King III.

6.2.3 Application of King IV

During the drafting of King IV, the King committee again attempted to broaden the scope of voluntary application of the King Code.

The King IV Report says[18] that the governing body of organisations (regardless of the legal nature of the organisation) is the intended audience of King IV. The Report states:

> '… A main objective of the King IV Report is to broaden acceptance of corporate governance by making it accessible and fit for application across a variety of sectors and organisational types.
>
> In pursuit of this goal the King IV Report includes supplements for specific sectors. In addition the Code itself has been drafted to be suitable for application by all organisations. This was done by phrasing *principles* and intended *governance outcomes* so that they embody the essence of the Code and can be applied with the necessary changes in terminology. The principles and intended outcomes being the essence, the *practices* can be then adapted and modified as suitable for the sector and in accordance with the proportionality considerations …' (Authors' emphasis.)

In other words, it is intended that all types of entities apply either the Recommended Practices in King IV, or any other (their own) practices, provided that the practices applied by that entity result in good governance (the defined governance outcomes) and can be shown to contribute to the achievement of the Principles.

6.3 Structure of King IV

The King IV Code is divided into 5 Parts, as follows:

- Leadership, ethics and corporate citizenship
- Strategy, performance and reporting
- Governing structures and delegation

[18] King IV p 35.

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- Governance functional areas
- Stakeholder relationships

The governance functional areas (fourth bullet above) deal with specialist areas that are of particular relevance to governance. These are:

- Risk governance
- Technology and information governance
- Compliance governance
- Remuneration governance
- Assurance

6.3.1 Principles vs Practices

Each Part of the King IV Code consists of one or more Principles. In total, the Code has 17 Principles, but the last Principle (Principle 17) applies only to institutional investors.

The Code requires that the first 16 Principles be applied by all organisations. Entities are not, however, required to apply the Recommended Practices proposed in the Code. Entities are required to disclose the practices that they do apply to achieve the Principles (whether Recommended Practices from the Code, or different (their own) practices more appropriate to the nature of the entity).

6.3.2 Scalability of King IV

The King IV Report contains 'sector supplements' which illustrate how the Recommended Practices can be scaled or adjusted to be relevant to entities other than big companies, for example non-profit organisations, municipalities and small and medium enterprises.

Listed companies would typically strive to implement most or all Recommended Practices in the King IV Code, but smaller entities are encouraged to implement such governance practices as are appropriate to their own organisation. The application of King IV to smaller entities is discussed in more detail in chapter 20.

6.3.3 'May', 'must' or 'should'

King IV uses the term 'may' when referring to a recommendation and 'must' when referring to a legal requirement.

The term 'should' is used throughout the Code and is to be interpreted as follows:

- where used in Principles, indicates an ideal state;
- where used in Practices, indicates a recommended course of action that is particularly suitable (i e a 'strong' recommendation').

6.4 Evolution of manner of application of King codes: Comply, apply or explain

6.4.1 King III: 'Apply or explain'

The King III Report took some pains in explaining how it should be used, and follows the approach used in the Netherlands of '*apply* or explain'. It does so in

preference to '*comply* or explain' on the grounds that this 'could denote a mindless response to the King Code and its recommendations whereas the "apply or explain" regime shows an appreciation of the fact that it is often not a case of whether to comply or not, but rather to consider how the principles and recommendations can be applied'.[19]

6.4.2 King IV: 'Apply and explain'

King IV has moved from the principle of 'apply *or* explain' to 'apply *and* explain'. This approach is an original approach by the King committee and not based on international precedent.

With the drafting of the King IV Code the King committee was particularly careful to distinguish principles from practices. The 75 principles in King III (many of which were actually practices) have been reduced to the 17 Principles in King IV.

The reason that the King committee gives for also requiring an explanation, even where Principles are applied (the 'and explain' rather than 'or explain') is to compel entities to '*substantiate* a claim that good governance is being practiced'. Entities must, in other words, not merely state that they strive to achieve the governance principles, but also explain the practices they applied in order to achieve the principles.

7. Johannesburg Stock Exchange — the new corporate governance regulator[20]

The JSE has been supportive of the King recommendations and required compliance with a variety of aspects of King II, from September 2003.

The JSE's Listings Requirements stipulated certain King III recommendations that listed companies had to comply with (such as the appointment of a nomination committee). Additionally, listed companies were required to make a general disclosure (a 'narrative statement') of how they applied the principles in King III by providing explanations that enable their shareholders to evaluate how the principles had been applied. Where any 'non-compliance' with King III had occurred, listed companies were required to specifically provide reasons for such non-compliance.

Following the publication of King IV, the Listings Requirements were again updated to compel compliance with certain Recommended Practices (for example the obligation to seek non-binding advisory votes on remuneration and engagement with shareholders if such resolution is not supported by more than 75% of votes).

The obligation to publish information on the implementation of King IV[21] requires that all listed entities publish information in their annual reports on the implementation of the King IV Code, utilising the 'disclosure and application'

[19] King III, page 7.
[20] See also ch 17.
[21] Section 8.63 of the JSE Listings Requirements. See also chapter 17, Compliance.

regime provided for in the Code. (More information in this regard is provided in chapter 13.)

The JSE Listings Requirements contain the rules on corporate governance with which listed companies must comply (as opposed to the voluntary compliance envisaged in King IV).[22]

It is the stated policy of the JSE to continue to set rules that are in accordance with international best practice and, by so doing, to increase confidence in the South African equities market.

The Listings Requirements set out the rules to be followed by companies listed on the JSE and their directors (note that there are a number of licenced securities exchanges, but the JSE remains the biggest and most influential). Each director of a company on the JSE is required to sign a declaration acknowledging that the company is bound by the JSE Listings Requirements and also agreeing to be bound in his or her personal capacity.

Fines of up to R7,5 million per transgression may be imposed on individual directors for transgressions of the Listings Requirements. For companies the ultimate sanction is de-listing.

8. International codes of corporate governance

According to the Organisation for Economic Cooperation and Development (OECD) Corporate Governance Factbook,[23] published in 2017, national corporate governance codes have become increasingly common and are frequently updated, with 19 new or revised codes issued during 2015–2016. (The OECD itself has a set of corporate governance principles, updated in 2015[24]).

Internationally. the codes vary, at the one extreme, from suggested practices whose adoption is entirely voluntary, to rigid legal requirements, breaches of which carry financial or criminal penalties. The codes share a number of common themes and vary more in the matters which they emphasise rather than in principle.

The evolution of codes of corporate governance has many similarities to the history of accounting standards. In the 1970s every country with an established accounting profession outside the US (where standards were developed from the 1930s) sought to establish its own set of accounting standards. It was thought that each country's problems were unique and that it would be impossible to develop a common set of standards for all countries. In recent decades the growing globalisation of securities markets has put an end to such thinking. The possibility that we will one day have a single set of worldwide accounting standards for publicly held companies is no longer a pipe-dream — indeed there are now only two accounting standard-setters of consequence (the Financial Accounting Standards Board in the US, and the International Accounting Standards Board in London).

[22] In terms of the Financial Markets Act, No 19 of 2012.
[23] https://www.oecd.org/daf/ca/Corporate-Governance-Factbook.pdf.
[24] https://www.oecd-ilibrary.org/governance/g20-oecd-principles-of-corporate-governance-2015_9789264236882-en.

However, due to fundamental differences in the approach between the two standard-setting bodies, the convergence of IFRS and US accounting standards appears not to have made much progress over the last few years.

A similar trend of rapid development is discernible in the corporate governance arena. But corporate governance is still in the expansion phase, where individual countries see their own corporate governance needs as being unique and requiring special emphasis. For example, in South Africa the need to redress the racial inequalities of the past has led to specific governance rules facilitating black economic empowerment. In Mauritius, with its need to preserve the fragile ecology on which its main industry of tourism depends, the emphasis is on the environment.

In the interests of international harmonisation, it may be desirable to distil the essence of corporate governance out of the myriad codes and principles. This distillation should highlight the key principles which should be common to all codes and leave matters of regional emphasis to local regulation. The first step may occur in Europe, where the countries of the European Union continue to grow in number. It is inconceivable that a financial market that prides itself on being an integrated whole can tolerate more than 30 codes of corporate governance. In addition, the governance scandals at companies such as VW, Parmalat, Siemens and Ahold will add to the pressure on the EU to impose legal rules similar to those in the USA.

A useful step in this direction was the issue of the revised Global Governance Principles of the International Corporate Governance Network (ICGN), in 2017.[25] This sets out key principles in eight succinct sections, and is augmented by Guidance in some specific areas.

Key issues which emerge in considering governance codes in developed nations are discussed in outline in the chapter which follows — these matters, and many less controversial issues are then covered in the South African context in the remainder of the book.

[25] http://icgn.flpbks.com/icgn_global_governance_principles/#p=1.

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CHAPTER 2

International Developments in Corporate Governance

The world is a book and he who stays at home
reads only one page.

M K Frelinghuysen

1. Introduction

The financial crisis that affected world markets in 2008 and 2009 started in the United States of America but quickly spread across the Atlantic with repercussions around the world. Although many blamed the ineffective regulation of banks and other financial institutions as the main cause of the crisis, the prevailing systems of corporate governance in major economies also attracted a share of the criticism. It is not surprising therefore that international corporate governance codes and practices since 2009 have undergone widespread changes. In South Africa, King III, which was published in 2009, and the 2008 Companies Act, which came into force in 2011, anticipated some of the changes that were later introduced in other countries. Internationally, many countries are affected by similar issues, such as the environment, inequality, and unethical business leadership leading to corporate failures. In South Africa, the King IV Code, published in 2016, was developed to provide for emerging local and international corporate governance concerns. This chapter considers some of the steps taken in other countries to deal with the global, as well as their local governance challenges.

Corporate governance rules include voluntary codes, like King IV, while others take the form of binding regulations that must be complied with. A third category applies only to certain classes of organisations, such as rules for companies whose shares are listed on a stock exchange. The penalties for non-compliance with some of the new laws, regulations and other requirements are severe.

Although similarities in corporate governance rules exist between countries, few are identical. Many practices reflect thinking developed in one country and adapted to suit the circumstances of another. In South Africa, the development of King l through to King IV, as well as the 2008 Companies Act, owes a considerable debt to earlier pronouncements in other countries. For this reason it is useful for South Africans to be aware of new international trends, as they may foreshadow possible future codes and laws in South Africa.

In the United States, the Dodd–Frank Wall Street Reform and Consumer Protection Act was signed into federal law by president Barack Obama on July 21, 2010. Passed as a response to the late-2000s recession, it brought the most significant changes to financial regulation in the United States since the regulatory reform that followed the Great Depression.

The discussion which follows may use some of the corporate governance 'jargon' and touch on issues which have entered the debate as to what constitutes good corporate governance; later chapters in the book should clarify these matters.

2. Developments in the United Kingdom

The country whose corporate governance pronouncements and laws have had the greatest influence on South Africa is the United Kingdom. The 2008 financial crisis (followed by further corporate failures) is the indirect cause of the scope and number of new requirements affecting business in that country.

In the UK, the Financial Reporting Council (FRC) has been established as the independent regulator with responsibility for the code of corporate governance for companies. It also administers three separate councils that issue professional standards on accounting and actuarial practice, as well as audit and assurance.

Compliance with its pronouncements on corporate governance and accounting is compulsory for companies listed on the London Stock Exchange and the FRC is the ultimate arbiter in the UK of standards for the actuarial and auditing professions.

2.1 UK Corporate Governance Code 2018

The UK Corporate Governance Code 2018, effective from 1 January 2019, is the latest version of a document that was first issued by the Cadbury Committee in 1992. Its focus is on principles rather than detailed rules, and as a result it is considerably shorter than its predecessor. It has changed less over the years than its South African counterpart.

The significant changes brought about by the UK's 2018 Corporate Governance Code were summarised as follows:[1]

- 'There is an increased emphasis on the quality of relationships with a wider range of stakeholders. This includes a requirement for engagement with the workforce (which is defined broadly and may include, for example, agency workers). Engagement may be through one or a combination of a director appointed from the workforce, a formal workforce advisory panel, a designated non-executive director or other arrangements which are effective having regard to the circumstances of the company.
- Where 20 per cent or more of votes have been cast against the board's recommendation in relation to a resolution at a shareholder meeting, the company is required to announce what action it intends to take to consult shareholders to understand the reasons behind the result. An update on the feedback received and action taken should be published within six months of the shareholder meeting and a final summary included in the annual report and, if applicable, in

[1] Summarised by Richard Werner on 17/07/2018 (partner at Bryan Cave Leighton Paisner LLP) http://www.blplaw.com/expert-legal-insights/articles/publication-of-the-2018-uk-corporate-governance-code.

CHAPTER 3

Types of Business Entities

> Everything that is properly business we must keep carefully separate from life. Business requires earnestness and method; life must have a freer handling
>
> Goethe

1. Introduction

The third King report took the bold and ambitious step of stating that it should be applied to all entities. This is stated quite categorically — 'regardless of the manner and form of incorporation and establishment and whether in the public, private sectors or non-profit sectors' (p 17). However, experience suggests that the translation of the extensive principles and practices of King III, drafted with a view to complex and well-resourced companies, was difficult to do and not commonly done in practice.

With the drafting of King IV, the King Committee has made a concerted effort to ensure that the King IV Code is accessible to various types of organisations, by:

- using a broader form of address, for example 'governing body' instead of 'board of directors' and 'organisation' instead of 'company';
- including Sector Supplements, intended to provide high-level guidance on how the King IV Code should be interpreted and applied by a variety of sectors and organisational types (see Chapter 6 of the King IV Report);
- distinguishing more consistently between Principles, on the one hand, and Recommended Practices proposed in order to achieve the Principles, on the other. The clear distinction makes it easier to understand what the fundamental governance aspirations are (relevant to all types of organisations) and the manner in which an organisation achieves the Principles, being 'practices' to be adapted to suit the nature of the relevant organisation. In this regard:
  - — King IV requires a 'qualitative' approach—Recommended Practices should be applied in a manner that is *proportional* to the size (turnover and workforce), resources and complexity of an organisation; and
  - — organisations are encouraged to adopt practices (whether the Recommended Practices or the organisation's own practices) only if the practices are suitable to the organisation's unique circumstances. The Recommended Practices serve as guidance on 'best practice'.

The types of organisations recognised in South African law, whether profit-oriented or not, range considerably. The specific characteristics of each of these will determine the extent to which formal corporate governance should be applied.

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1.1 Determining the extent to which an organisation should apply formal corporate governance

1.1.1 The nature of the organisation's activities

The size (both with respect to turnover as well as number of employees), resources and complexity of an organisation will affect the nature of its governance practices. The impact of the activities of an organisation on society and the environment is also an important consideration. Clearly, the bigger and more complex an organisation is, or the more extensive its impact on society and/or the environment, the more formal and extensive its corporate governance practices should be.

1.1.2 Nature and extent of stakeholders

Stakeholders may include an organisation's owners, employees, creditors, customers, or any other person or group which affects or is affected by the organisation's activities. The need for corporate governance is influenced by the number and variety of an organisation's stakeholders, as well as the extent to which these stakeholders are involved in the management of the organisation.

Where there is a separation of ownership and management, the protection of the owners will always be an important reason for implementing more extensive formal governance, given that the owners may not have ready access to business information.

Smaller organisations with fewer stakeholders, for example entities which exist for charitable purposes, may have a more modest need for formal governance processes, particularly if they are self-funded. However, even where a charitable organisation is self-funded, it may have stakeholders in the form of beneficiaries of its charitable activities who are materially impacted by the organisation's activities. If this is the case, additional safeguards in the form of formal corporate governance will be appropriate.

1.1.3 Legal nature of the organisation and governance imposed by law

The legal vehicle which houses an organisation (whether it is a company, trust, owner managed business, or unincorporated) determines the legal framework within which the organisation functions, and the nature of corporate governance practices that are required by law. For example, the legal powers and responsibilities of a board of trustees are legally very different from those of a board of directors.

Where the interests of stakeholders are addressed by legislation, regulation, or contract, the need for formal corporate governance—as a separate function of the entity—will diminish.

For example, an owner-managed business where a single individual, the owner, trades on the stock exchange for his own account, lacks the separation of ownership and management. The only other stakeholder is likely to be the South African Revenue Service and possibly a bank as financier; the interests of the

CHAPTER 4

Strategy and its Execution

Where there is no vision, the people perish

Proverbs 9: 18

Strategy: a plan for successful action based on the rationality and interdependence of the moves of opposing or competing participants

Shorter Oxford Dictionary

1. The importance of strategy

Before we can implement good corporate governance in a company, we have to understand the company's purpose—what it plans to do and how it plans to do it. In other words, we have to understand its strategy. In this chapter we look at the process of strategic planning and how it impacts the way that a company is run.

We judge the success or failure of a company by whether it achieves its purpose. In practice we do this by measuring achievements against strategic objectives. What we may see as success in one case may be abject failure in another. Take the example of a company formed as a one-off venture to exploit a single mineral resource. If it completes the venture satisfactorily within the planned time limits, making profits as expected, and is then liquidated, it has achieved its purpose and is a success. On the other hand, if a company intending to be in the retailing business for an indefinite period were to be liquidated after a few years, we would see it as a failure. Success or failure in achieving strategic objectives is usually the best measure of a company's performance, whatever those goals may be. Success in achieving strategic objectives should also be the primary focus of each board of directors.

Strategy includes deciding what business a company should be in, who its customers are, against whom it will be competing, and how it will measure success. It also includes setting objectives, defining its mission or purpose, evaluating the environment within which it must operate, defining its key stakeholders, determining its competitive advantage, formulating detailed plans to accomplish its aims and putting them into effect.

The word 'strategy' is derived from the Greek and refers to the art of a commander-in-chief or general. The strategy of a company, like that of an army, should not be conceived in a vacuum, but should take into account the activities of competitors, changes in customers and their preferences and the myriad of other outside factors which affect it every day.

Studies in the USA and UK in the 1990's to determine what investors found most valuable in company reports cast new light on strategy. The surveys showed that information regarding the *execution* of strategy—how well it has been carried

out—earned the top rating and information about the *quality* of the strategy itself ranked next. Apart from providing a lesson for companies on what they should tell their stakeholders, these surveys also underlined the point that investors see good strategy, well executed, as vital to the success of any enterprise.

Professor Michael E Porter of Harvard Business School on competitive strategy:

> 'The essence of formulating competitive strategy is relating a company to its environment ...'

Management guru Peter Drucker defined strategic planning as:

> '... the continuous process of making present entrepreneurial (risk-taking) decisions systematically and with the greatest knowledge of their futurity; organizing systematically the efforts needed to carry out these decisions; and measuring the results of these decisions against the expectations through organized, systematic feedback.'

2. Corporate governance and strategy

Well-developed and effective strategy requires good corporate governance.

> 'If strategy formulation and execution are among the most important responsibilities of the directors of a company, then a vital requirement for corporate governance is to ensure that nothing hinders the effective performance of those two functions.' ('Measures that Matter' Ernst & Young).

This view is endorsed by King lV, viz—

> 'The governing body should assume responsibility for organisational performance by steering and setting the direction for the organisation's core purpose and values through its strategy' (King IV, p 47, 4.1).

Strategy formulation is usually the responsibility of executive management, while the non-executive directors should bring objectivity and a diversity of experience to the task of evaluating and approving it. King IV specifically states that the governing body should delegate the formulation and development of short, medium, and long-term strategy to management (King IV, p 47, 4.2).

The governing body should constructively challenge and debate the assumptions on which the strategy is based as well as the risks and opportunities flowing from those assumptions. In doing this, King IV recommends that the governing body should have reference to—

- Timelines and parameters determining the meaning of short, medium and long term;
- Risks, opportunities and other significant matters connected to the organisation's triple context (i e economy, society and environment);
- The extent to which the proposed strategy depends on the resources and relationships connected to the various forms of capital;
- The legitimate and reasonable needs, interests and expectations of material stakeholders (see 4 below);
- The increase, decrease or transformation of the various forms of capitals that may result from the execution of the proposed strategy;

CHAPTER 5

Composition and Selection of the Board of Directors

The ultimate measure of a man is not where he stands in moments of comfort, but where he stands at times of challenge and controversy.

Martin Luther King

1. Composition of the board of directors

1.1 General

The effectiveness of a board of directors will depend very much on the people involved. The interaction that takes place at board meetings should be such as to ensure rational, objective and independent decision-making in the best interests of the enterprise.

Ram Charan states that the three characteristics of what he terms a 'progressive' board are:

- 'group dynamics', being the 'tenor of interactions among board members and between the board and management';
- how the board gets information and in what form; and
- the ability of the board to focus on substantive issues in order to add value.

Boards that Deliver 2005, p 5

In dealing with the composition of the board of directors, consideration will have to be given to the various responsibilities which the board must discharge — clearly the board should collectively possess the skills which will enable it to do so.

Directors' responsibilities in law are discussed in the chapter which follows. The King Report and the accompanying Code add recommendations on the manner in which these should be exercised. The extent of directors' responsibilities is evident throughout this book; rather than listing them all here, suffice it to note that the underlying mindset is contained in Chapter 2 of the King IV Report, which states that, fundamentally, corporate governance is the exercise of ethical and effective leadership by the governing body (i e the board) to achieve the four governance outcomes of (i) ethical culture, (ii) good performance, (iii) effective controls and (iv) legitimacy (King IV, p 20).

1.2 Meaning of 'director'

The responsibilities of directors are onerous, so it is important to understand exactly what is meant by the word 'director', which seems to suggest some importance. The term is sometimes loosely used to describe somebody's job function

within an organisation, e g 'director of human resources', when the person concerned is not, in fact, a director (i e a member of the board) in terms of the Companies Act.[1]

The definition in the Companies Act is not particularly helpful, as it simply states that a 'director' means (i) a member of the board of a company, as contemplated in s 66,[2] or (ii) an alternate director and (iii) 'includes any person occupying the position of a director or alternate director of a company, by whatever name designated' (Companies Act, 2008, s 1).

1.2.1 'De facto' director

In contrast to the situation where a person carries the title of director, but is not in fact a director, the Companies Act definition of director implies that a person who does not carry that title, but is de facto (i e in fact) acting as a director, could be treated as a director for the purposes of the Act. There could, for example, be circumstances where a person did not wish to be designated as a director (for example, because he or she did not wish his or her remuneration to be disclosed — see Chapter 18, or where American titles are used by the company, such as 'Vice-President'); but such a person is nevertheless brought within the definition of director for the purposes of the application of the Companies Act. In such a case it is probable that the person in question would, in any case, fit the definition of 'prescribed officer' (see 1.9 below).

1.2.2 Extended definition of director for purposes of liability

It is also important to note that for the purposes of directors' liability in terms of s 77[3] of the Companies Act, the definition of 'director' includes:

- Alternate directors and 'de facto' directors, referred to in the definition of directors;
- Prescribed officers; and
- Persons who are members of a committee of the board, or of the audit committee even though they are not members of the board itself.

1.2.3 Alternate directors

It is interesting that the definition of director includes an alternate director. The Memorandum of Incorporation may give a director the power to nominate someone to act as alternate director in his or her place, when (the appointing director is) absent or unable to act as director. This appointment will be approved

[1] The practice of bestowing the title of 'director' on an individual who is not appointed to the board is risky, as it may have the result that the individual may be legally liable and/or may bind the company to the third parties as if the individual did, in fact, have the authority of a director.

[2] Section 66 does not define 'director', and deals mostly with the number of directors and their appointment.

[3] There are a number of other sections in the Companies Act where the extended definition of 'director' is used in the context of duties and liabilities, including ss 75, 76 and 78.

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CHAPTER 6

Directors and their Responsibilities

The non-executive directors might just as well have been playing bowls on a hot Sunday afternoon for all the energy they put into the discharge of their duties.

Myburgh report on the (collapsed) Regal Treasury Private Bank (2001, p 38)

1. General

The rights and duties of directors derive from three main sources:

- The Companies Act;
- The company's Memorandum of Incorporation (MOI) (entitled Memorandum and Articles of Association under the 1973 Act[1]);
- The common law.[2]

Principle 1 (p 43) of the King IV Code provides that the board should lead *ethically* and *effectively*. The authors suggest that any person considering a directorship of a company should ensure that he or she is prepared to fulfil the character requirements required to do so. Directors should be competent, committed, and aware of their fiduciary duties to the company and the responsibilities of oversight which they carry.

The rights of individual directors are relatively modest, while their responsibilities are considerable. It is therefore important that anyone assuming the role of director, particularly in the case of a listed company, should be aware of these rights and duties. We have already referred to induction of directors in Chapter 5 and it is strongly recommended that such induction programmes should include a review of directors' rights and duties.

It is not the purpose of this book to set out comprehensively the rights and duties of directors, but some of the more important aspects are nevertheless highlighted below. It should also be borne in mind that, in addition to the general duties set out below, there are other duties arising in relation to specific classes of company, notably those that are listed and thus subject to the Listings

[1] Whether a company has formally replaced its Memorandum and Articles of Association or not, the transitional provisions of the 2008 Companies Act provide that the constituting documents of a South African company are now known as its Memorandum of Incorporation.

[2] Common law refers to the part of South African law that is derived from custom and judicial precedent, rather than statute. For example, most of the principles of the law relating to trusts have developed over the years from a combination of Roman Dutch and English tradition and its interpretation by our courts. The South Africa legislation that does deal with trusts (the Trust Property Control Act No 57 of 1988) regulates limited aspects of trust law—the rest of the law is, essentially, tradition. Similarly, there is a significant part of company law and the duties of directors that developed in the common law, has legal force and is relevant to directors, but is not incorporated in the Companies Act.

Requirements of the Johannesburg Stock Exchange, and those subject to specific regulation, such as banks and insurers.

In considering directors' rights and duties, readers may recall that the Companies Act does not distinguish between executive and non-executive directors. What follows is equally applicable to both.

2. Rights of directors

Compared to their duties, the rights of individual directors are very limited (as a board, however, their powers are massive,[3] being limited only by what is contained in the company's MOI and in the Companies Act itself — such as s 41, which requires shareholder approval for the issue of shares in certain circumstances). It is important to understand that, unless specifically authorised by the board or the MOI, a single director cannot act on behalf of the board. Hence, clear delegation and authority levels, particularly for executive directors, are important.

As explained in Chapter 7, directors have a legal right to inspect the company's books and accounts. However, a director has no right to remuneration. Note that a director is an 'officer' of the company and not an employee of the company; an executive director would be both an employee as well as an officer of the company.

In the case of executive directors, who are also employed by the company, their remuneration will generally be regulated by their employment contracts. Such remuneration is, typically, paid for the individual's executive management services, rather than for his or her services as director. Often executive directors do not receive additional remuneration for their service to the company as director.

In order to be entitled to make payment to directors *for their services as directors* (i e 'directors' fees'), the company requires a special shareholders' resolution, not older than 2 years. In the event that shareholders do not approve the proposed directors' fees, no remuneration may be paid.

Directors will exercise certain rights as a result of fulfilling their duties. For example, they must have the right of access to company management and company premises. The Code recommends that the board approves a protocol in terms of which members of the board request documentation and set up meetings with management (p 49; 6; 4).

A non-executive director should observe normal courtesies in exercising these rights; i e it should not be done in a way that will impede executive directors and managers in their day-to-day running of the company. This right is not unlimited, but relates to the fulfilment of the director's duties. For example, if a non-executive director of an investment company were to seek information as to the specific investments being made, for the purposes of guiding his or her personal

[3] Section 66(1) of the Companies Act provides that 'The business and affairs of a company must be managed by or under the direction of its board, which has the authority to exercise all of the powers and perform any of the functions of the company, except to the extent that this Act or the company's Memorandum of Incorporation provides otherwise.'

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CHAPTER 7

Functioning of the Board

The purpose of a meeting is to bring depth and breadth of discussion to a problem that merits the attention and effort of every member present.

Alfred J Marrow

1. Introduction

In Chapter 4 we saw the importance of strategic planning in providing direction for the company. It is the responsibility of the board as a whole to provide this strategic direction. In addition to the specific responsibilities of individual directors, which are covered in Chapter 6, the remaining collective responsibilities of the board, are dealt with in this chapter. These duties are best summed up in Principle 1 of King IV (p 43):

'The governing body should lead ethically and effectively[1]'.

2. Board effectiveness

There is general agreement that an effective board of directors is vital to the long-term success of a company. But for a board to be effective is not easy. Consider that most directors of a company spend a small fraction of their available time on its business. Consider also that key members of a public company's board are independent non-executives, whose initial knowledge of the company's business is necessarily limited and who rotate off the board at regular intervals. Consider the difficulties of understanding the factors that lead to success or failure in a large and complex business. And consider that those charged with ultimate responsibility for that success or failure are mainly part-timers who rely on management to keep them informed about the company's business.

Board effectiveness is the result of many factors, including:

- Competent, ethical non-executives with a diverse range of skills (Chapter 6);
- Well-understood and properly functioning board rules and procedures;
- A flow of accurate, complete, up-to-date and relevant information on the company's performance;
- An effective chair and well-run meetings;
- An effective management team;
- Competent and well-run board committees;
- Clear channels of communication, trust and understanding between the board and the Chief Executive Officer (CEO) and management team; and
- Good systems of risk management and control (Chapter 9).

[1] Defined in King IV (12) as '*The adequate accomplishment of the desired objective or a pursuit with the minimum expenditure of time, resources, waste and effort*'.

In 2008 AIG, America's largest insurance company, incurred massive losses from uncovered risks in one small division. AIG was saved from collapse by a $150 billion US Government bailout. Here is a company that is actually in the business of risk management but which failed to manage its own risks. This event illustrates the difficulties faced by directors of a large company or conglomerate who know very little about its activities at divisional or subsidiary level.

3. Board rules, procedures and charter

The cardinal importance of the board as a unit, rather than the chief executive officer (CEO), the chair or the individual directors, is clear both from company law and King IV. The board's powers and responsibilities are wide — so wide that they are defined by exception. The 2008 Companies Act states that the board 'has the authority to exercise all of the powers and perform any of the functions of the company, except to the extent that this Act or the company's Memorandum of Incorporation provides otherwise' (s 66(1)). Thus the board generally has the power to do anything that is not reserved for shareholders (or in limited instances, the audit committee[2]). One of the first tasks of a board is usually to appoint the CEO and other key members of management. As we have seen, it also determines the direction and strategy of the company (see Chapter 4).

The board is the focal point and custodian of corporate governance

King IV's Principle 6[3] reads as follows:

'The governing body should serve as the focal point and custodian of corporate governance in the organisation'. The report goes on:

1. 'The governing body should exercise its leadership role by:
   a. Steering the organisation and setting its strategic direction;
   b. Approving policy and planning that give effect to the direction provided;
   c. Overseeing and monitoring of implementation and execution by management; and
   d. Ensuring accountability for organisational performance by means of, among others, reporting and disclosure.
2. The governing body should ensure that its role, responsibilities, membership requirements and procedural conduct are documented in a charter which it regularly reviews to guide its effective functioning.'

Under the 2008 Companies Act, every company has a Memorandum of Incorporation (under the previous Act this consisted of two documents, the 'Memorandum of Association' and the 'Articles of Association') that is, in effect, the constitution of the company and provides the legal framework within which it operates. Thus the board does not work in a vacuum, but within the constraints of the Companies

[2] Section 94(10) provides that the appointment, fees and terms of engagement of the external auditor is the sole prerogative of the audit committee.
[3] King IV, page 49.

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CHAPTER 8

Board Committees

A committee is a group that keeps the minutes and loses hours.

Milton Berle

So much to do, so little done.

Cecil John Rhodes

1. The need for focused committees

The board of directors of a typical listed company in South Africa meets together for less than 48 hours a year — a surprisingly short time to accomplish all that is expected of it. Although the modern company's affairs are run on a day-to-day basis by management, the formal board meeting is the time when the board as a whole, executives and non-executives, comes face-to-face for the sole purpose of discussing the company's strategy and its implementation. These organisations control the working lives of thousands of people and manage billions of rands in assets and liabilities. How do they do it effectively in less than two days a year?

Part of the answer is that, like an iceberg that is mostly underwater, much of the work is done in preparation for the board meeting rather than at the meeting itself. Another part is that some issues are dealt with in a focused way in two stages — firstly, at a committee level, and later — and more briefly — by the board as a whole based on the report of the committee members. This recognises both the scarcity of time available to the whole board and the need for a more direct focus by directors with specialist knowledge on certain important governance areas. Most listed companies now have board committees to examine such topics and report back to the main board.

1.1 Companies Act requirements

Under the Companies Act (s 94) the shareholders of every public and state-owned company must appoint an *audit* committee. This committee is not entirely a committee of the board in that it has a number of statutory duties, although in other respects it fulfills the functions of a board committee. The purpose and functions of an audit committee are dealt with separately in Chapter 11.

The Companies Act (s 72(4) and regulation 43) also requires public, state-owned and certain other companies to establish 'social and ethics' committees, unless exemption is obtained on the grounds that:

- it already has a 'formal mechanism' in terms of other legislation that substantially performs the function of such a committee; or
- it is not reasonably necessary in the public interest for it to have such a committee.

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The regulations concerning the social and ethics committee are unusual in several respects and are discussed in Chapter 10.

1.2 King IV recommendations[1]

In the discussion of 'Highlights of the King IV Code' in Part 2 of the King Report, the Committee notes the following (p 29):

> 'King IV, like King III, deals with delegation by the governing body within its own structures. Principle 8 of King IV now clarifies the objectives for these delegation arrangements, which are to promote independent judgement; to assist with balance of power; and to assist with the effective discharge of its duties by the governing body.
>
> In accordance with the convention adopted for King IV, the recommended practices do not prescribe which committees should be established by the governing body—the governing body should judge what is appropriate for the organisation.'

The King IV Code recommends that the board gives consideration to the appointment of the following standing committees:[2]

- Audit committee (all members to be independent and non-executives)
- Committee responsible for nominations of members of the governing body (all members should be non-executive, with the majority being independent)
- Committee responsible for risk governance (should have executive and non-executive members, and the majority should be non-executive)
- Committeee responsible for remuneration (all members should be non-executive, with the majority being independent)
- Social and ethics committee (should have executive and non-executive members, and the majority should be non-executive)

This chapter explains the purpose of board committees, how they should operate and will warn of some of the traps that await the unwary. One of these traps is highlighted in s 72(3) of the Companies Act: 'The creation of a committee, delegation of any power to a committee, or action taken by a committee, does not alone satisfy or constitute compliance by a director with the required duty of a director to the company, as set out in s 76.' Furthermore, in terms of s 77, any person who is a member of a board committee, but not of the board itself, faces the same liability as that of a director (even though he or she may have limited insight as to what is taking place at board level).

As mentioned in Chapter 3, private and small non-profit companies are often able to dispense with committees altogether and to deal at board level with the matters that would normally be considered by committees.

[1] The Institute of Directors of Southern Africa published a Practice Note in February 2018 (available on its website at www.iodsa.co.za) in which it explains the approach recommended by King IV in respect of board committees.

[2] The King IV Code does not intend to be prescriptive on the types of committees to be appointed; hence the reference to 'committee responsible for … governance'. For purposes of this chapter and in the interests of simplicity the authors refer to these committees as the nomination committee, remuneration committee and risk committee.

CHAPTER 9

Risk Management and Internal Control

There is no security on this earth, there is only opportunity

General Douglas MacArthur

One of the largest trading losses in history took place in almost the blink of an eye, with no warning signal

The Black Swan — Nassim Nicholas Taleb

1. Risk and opportunity

Uncertainty surrounds us — it is part of our lives whether we like it or not. The negative kind of uncertainty we label *risk*, while the positive kind we call *opportunity*. Success in business and in life results from exploiting opportunities, but managing risks.

This chapter looks at managing the risk side of the equation, noting, however, that both risk and opportunity can potentially arise from the same set of facts (for example the risk of global warming also presents opportunities to sell products that improve energy efficiency). Risks are not always easy to manage — some risks (like earthquakes) are always present but are difficult or impossible to control, while others (like new diseases) sneak up and take us unawares. Effective risk management requires constant vigilance — both in reacting to known risks and in watching out for new ones.

Every gardener will understand that a completely sterile garden is less fertile than one with the living organisms that create humus and compost. In business, a company that reduces risks to an absolute minimum will seldom produce above average results. Ultimately, managers who pay too much attention to the negative aspects of their business may find that their biggest risk is that they miss opportunities.

Every company has a different appetite and tolerance for risk depending on the nature of its business, the extent of its financial and other resources and above all, the attitudes and abilities of its people. A company's tolerance for risk and its approach to risk management are strategic issues that must be decided by the board of directors and become embedded in its strategies and culture rather than being left to the whims of individual managers.

> 'Enterprise risk management is a process, effected by the entity's board of directors, management, and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within the risk appetite, to provide reasonable assurance regarding the achievement of objectives.'
>
> Committee of Sponsoring Organisations of the Treadway Commission (COSO)'s Enterprise Risk Management — Integrated Framework (2004)

One of the biggest dangers in dealing with risk is the assumption that we can predict all or most eventualities and that risk management is simply a matter of dealing with potential problems that have already been identified and analysed. As Nassim Taleb, the author of *The Black Swan*, tells us — 'life is the cumulative effect of a handful of significant shocks'. His thesis is that history is determined by major unforeseen events — not by the everyday happenings that we spend most of our time focusing on. The lesson is that risk management strategies should never discount the likelihood and potential impact of highly improbable events.

Some risks are unpredictable. The author of *The Black Swan* would argue that it is neither possible nor economically justifiable to anticipate every possible risk, improbable or not.

The Companies Act appears to recognise that risk taking, provided that the risk taken does not amount to recklessness, is an integral part of commerce. Section 76(4) of the Act contains the so-called business judgement test, discussed in Chapter 6. In summary, a director is able to excape liability for the exercise of powers that eventually led to a loss to the company if the director took reasonably diligent steps to become informed on the matter, dealt with any conflicts of interest in accordance with the Companies Act and behaved rationally.

In the view of the authors, risk management can play an important role in assisting companies to avoid or reduce many of the risks that businesses face, and provides a useful framework for ensuring sound and cost-effective systems of internal control. However, it is essential to appreciate the inherent limitations of risk management systems and to recognise the possibility of unpredictable events that may threaten a company's future.

2. King IV's recommendations on risk management

King III devoted an entire chapter to the governance of risk. King IV has substantially condensed the information into a single principle, namely Principle 11, which reads: 'The governing body should govern risk in a way that supports the organisation in setting and achieving strategic objectives.'

Principle 11[1] emphasises the responsibility of the board and includes the following main elements:

- It encompasses:
  - — both opportunities and associated risks to be considered when developing strategy;
  - — the positive and negative effect of the same risks on the achievement of organisational objectives;
- Risk should be an integral part of the way the company makes decisions;
- The board should approve policy that articulates and gives effect to its direction on risk;
- The board should agree the nature and extent of the risks that the company is willing to take in pursuit of its objectives, in particular:

[1] p 61, Principle 11, 1–7.

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CHAPTER 10

The Social and Ethics Committee

'Ethics is in origin the art of recommending to others the sacrifices required for cooperation with oneself.'

Bertrand Russell

'The possibility that ethical and commercial considerations will conflict has always faced those who run companies. It is not a new problem. The difference now is that a more widespread and critical interest is being taken in our decisions and in the ethical judgements which lie behind them.'

Sir Adrian Cadbury

1. Introduction

Every listed company and state-owned company (as well as certain others, as explained at 4 below) is obliged in terms of s 72 and regulation 43 of the Companies Act, 2008, to set up a social and ethics committee ('S&E Committee'). This committee is unique to South Africa. Its nature and purpose highlight the sharp divide between the principles of corporate governance as applied in South Africa on the one hand and those of an unashamedly capitalist country like the USA on the other. For example, in the USA (according to the New York Stock Exchange Commission on Corporate Governance):

> 'the board's fundamental objective should be to build long-term sustainable growth in shareholder value for the corporation, and the board is accountable to shareholders for its performance in achieving this objective.'

Regulation 43 of the South African Companies Act, 2008 on the other hand implies that, in addition to its responsibilities to shareholders, a board is also required to give its full attention to the matters that the social and ethics committee must monitor and report on. These duties are set out under the following headings:

- Social and economic development
- Good corporate citizenship
- The environment, health and public safety
- Consumer relationships
- Labour and employment

The matters spelt out in Regulation 43 would normally form part of the broad responsibilities of every board of directors, but would seldom have received the direct attention of the board, unless the circumstances were unusual. By creating a specific statutory duty for the S&E Committee to monitor and report on each of these matters, both to the board itself and to shareholders, the Act imposes a higher duty on the board to consider them than would otherwise be the case,

even if their impact on the company and its stakeholders may be slight. This obligation detracts from the board's discretion to prioritise the matters that it believes should receive its attention. It also means that the building of shareholder value could possibly get less attention in South Africa than in a country such as the USA.

There is an exemption provided for in s 72(5) of the Act, if it is 'not reasonably necessary in the public interest' to have an S&E Committee, 'having regard to the nature and extent of the activities of the company' (this has to be approved by the Companies Tribunal and the exemption may only be granted for up to 5 years at a time). The exemption will cater, for example, for companies which are purely of an investment nature.

A curious oversight in the list of matters to be monitored by the committee, especially given the committee's name, is the absence of any reference to codes of conduct or ethics. The prevention of corruption and the need for equality get several mentions, but ethics in a broader sense is notably absent. As mentioned below, some companies have chosen to expand the terms of reference of their committee to include ethics.

The members of the committee (at least three in number), must be directors or prescribed officers of the company, at least one of whom must not have been involved in its day-to-day business within the previous three years. Unlike the audit committee, which is the only other committee required by the Act, the members of the S&E Committee are presumably appointed by the board (the Act and regulations are silent on this point (s 72 and Regulation 43(4)).

2. King IV

King IV regards the S&E Committee as an important mechanism through which oversight can be exercised. In fact, it seeks to expand the role of the S&E Committee[1] and provides that[2] its role is (i) oversight of and (ii) reporting on:

- organisational ethics;
- responsible corporate citizenship;
- sustainable development; and
- stakeholder relationships

The matters recommended by King IV to be dealt with by the S&E Committee are indeed more extensive that the list included in Regulation 43 (discussed at 4 below).

In addition to the entire new class of responsibilities (organisational ethics), King IV refers to the wide-ranging topics of responsible corporate citizenship (presumably covering the matters set out in Principle 3 (p 45)) and sustainable development (as defined on p 18). Where Regulation 43 covers only some aspects of the last three topics listed above, King IV recommends that the S&E Committee oversees and reports on the entire subject.

[1] p 29, Part 2, 'Highlights of the King IV Code'.
[2] p 57, Principle 8, 68.

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CHAPTER 11

The Audit Committee

It is more tolerable to be refused than deceived

Publilius Syrus

1. Background

The audit committee is the principal governance watchdog in most companies and was the first governance committee to gain broad acceptance in the business community. It has been obligatory for companies listed on the New York Stock Exchange for many years (first endorsed in 1939, and made mandatory in 1977) and has become widely used in South Africa since the publication of the first King Report in 1994. Its purpose is to provide additional focus on financial issues that are vital to the company but which often cannot be fully examined by the main board because of the shortage of time available to the board. As a separate committee, generally composed of board members with the relevant financial skills, it is able to deal with issues of finance, control and risk in greater depth than the main board.

Past corporate failures have highlighted the need for a strong and objective review of financial information produced by companies. To achieve this, the independence, and competence of the audit committee must be assured. In South Africa, this has been taken to considerable lengths, to the extent that the audit committee has become a statutory committee in terms of the Companies Act (for certain categories of companies). Its importance is such that it warrants a chapter to itself.

The King IV Code deals with audit committees, as part of Principle 8, namely 'The governing body should ensure that its arrangements for delegation within its own structures promote independent judgement, and assist with balance of power and the effective discharge of its duties' (King IV, p 54).

This is much less detailed than was the case with King III, which devoted an entire chapter to audit committees, containing 10 principles, and considerable commentary.

2. Statutory requirements

The Companies Act requirements for audit committees stand separately from the question of whether an annual audit is required (obviously, though, if no audit is required, an audit committee becomes redundant).

Quite simply, all public companies and state-owned companies must have an audit committee. Other types of companies may have to have an audit committee if the Memorandum of Incorporation requires this. It may also be sensible for other organisations (such as large non-governmental organisations) to have an

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audit committee if their size or nature of activities makes this desirable. There are also some types of business, not necessarily conducted through companies, where there is a further statutory requirement for an audit committee (notably banks, in terms of the Banks Act of 1990, insurance companies under the Long—and Short-term Insurance Acts, and medical schemes in terms of the Medical Schemes Act of 1998).

Companies that are required to have an audit committee by the Companies Act, must elect the audit committee at each annual general meeting.[1] This is therefore a function of the shareholders, not the board, and clearly a deliberate decision of the legislature. It enables the shareholders to have direct control over who protects their interests in the area of financial reporting and control.

The audit committee must comprise at least three members who must be *independent* directors (s 94(4)(*b*) and (*c*) spell out how this is to be determined); note that the meaning is not the same as that applied in King IV in determining whether a director is independent). It is thus not enough that they are non-executive directors. The committee must also, collectively, possess minimum qualification requirements, to be prescribed by the Minister of Trade and Industry (s 94(5)).

These qualifications are set out in Regulation 42 to the Act and are very undemanding. At least one-third of the members of the committee (and thus potentially only one member) must have qualifications *or* experience in 'economics, law, corporate governance, finance, accounting, commerce, industry, public affairs or human resource management'. Thus on a three person audit committee a solitary human resources practitioner would provide the necessary qualifications for the purposes of the Act—for the functions that an audit committee will typically be required to perform this would be hopelessly inadequate. It is also puzzling that actuarial science is not listed as a qualification.

In groups of companies, it is conceivable that there may be a number of subsidiaries that are also public companies requiring their own audit committee. This could be extremely bureaucratic, and there is therefore provision in the Act (s 94(2)) allowing the audit committee functions to be performed by a single committee, i e that of the parent company.

Section 94 spells out a number of duties of the audit committee. These do not mesh tidily with the King IV Code We have followed the approach of the King Report, but have noted specific statutory responsibilities at the relevant point (see 5 below).

Finally, it is important for board members to appreciate that the existence of the audit committee as a creation of statute does not absolve the board of responsibilities in relation to matters handled by the audit committee. Section 94(10) of the Act explicitly states that neither the appointment nor the duties of the audit committee reduce the functions or duties of the board and the directors, except in relation to the appointment, fees and terms of engagement of the external auditor.

[1] Companies Act, s 94(2).

CHAPTER 12

Financial Reporting and Communication

> Communicate unto the other guy that which you would want him to communicate unto you if your positions were reversed.
>
> Aaron Goldman

> Everyone is entitled to their own opinion but not their own facts
>
> Daniel Patrick Moynihan

1. Introduction

In terms of accountability to stakeholders, the traditional model has been that of reporting to the shareholder, rather than to other users of financial statements. This reflects the traditional role of the shareholder as the provider of risk capital.

This traditional model was embodied in the requirement of s 302 of the old Companies Act to the effect that every member should receive a set of annual financial statements of the company; in practice this led to large listed companies sending out numerous annual reports which were simply discarded by shareholders. More sensibly, the 2008 Act provides for shareholders to receive notice of publication of the annual financial statements, and the right to receive a copy on request (s 31).

Public companies must also present interim reports, which are either unaudited or reviewed. In addition, the practice has evolved for listed companies to publish a preliminary profit announcement, usually containing the audited figures, prior to the issue of the annual integrated report (if the figures are not audited, they may have been reviewed in the same manner as is sometimes done in respect of the interim figures). This permits time for non-statutory disclosures, such as a chairman's statement, to be included in the annual report and for it to be prepared in an attractive format (these documents are thus often referred to colloquially as 'the glossies'). Johannesburg Stock Exchange (JSE) rules (Listings Requirements 3.21) require listed companies to publish an abridged version of their annual financial statements on the JSE electronic news service (SENS) as soon as they are issued.

In addition to the traditional format, public companies are increasingly using electronic media and their websites as a means of conveying information.

2. General communication principles

Principle 5 of the King IV Code states that the governing body should ensure that reports issued by the organisation enable stakeholders to make informed assessments of its performance and its short, medium and long-term prospects. This is followed by a number of recommended practices.

The management of stakeholder relationships is covered in Chapter 14. As discussed in chapter 1, it is essential that boards recognise that they are dealing with a variety of stakeholders in the enterprise — not merely the shareholders, but also employees, creditors and the general public.

In communicating with stakeholders, some general principles were stated as long ago as 2002 in the second King Report and Code, yet are still valid. These are that:

- the board has a duty to present a balanced and understandable assessment of the company's position;
- the quality of information should be based on principles of openness and substance over form;
- reporting should address material matters of significant interest and concern to all stakeholders (King Code (2002) 8.1).

The general approach taken by King IV is that the governing body should oversee the publication of such reports and information as are required to:

- comply with legal requirements; and
- meet the legitimate and reasonable information needs (financial and non-financial) of material stakeholders.

An annual 'integrated' report can be used as a vehicle to connect the more detailed information in other reports and address, in a complete and concise manner, the matters that could affect the company's ability to create value, as a standalone report.

Alternatively, the integrated report can form part of a collated document containing the financial statements and other required reports. Guidance for this is provided by the International Integrated Reporting Committee (IIRC), and the integrated report envisaged by the IIRC is dealt with in chapter 13. It is clear that the integrated report will contain considerably more information than is embodied in the statutory financial statements.

The requirement to prepare an integrated report applies to all entities falling within the ambit of the King Report, and will thus in principle apply to the small owner-managed company in the same way as it does to a major global company with a multitude of shareholders. However the concept of proportionality introduced into King IV implies that smaller entities cannot be expected to produce an integrated report on anything like the scale that is already evident in the (integrated) annual reports of major listed companies; indeed, it is unlikely that many of them will take any notice at all. They have a narrower stakeholder base (if owner-managed, there may be no employees) and their impact on society may be minimal. Their reporting focus will be on the owners, the State, to whom taxes fall due, and outside funders such as bankers and thus mostly on profitability and cash flows (traditional reporting metrics) rather than on the 'bigger' issues such as impacts on the environment and society generally—which may be highly relevant in the case of the large global company.

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CHAPTER 13

Integrated Reporting

> 'One of the benefits that companies have seen in adopting integrated thinking is in the development of their business strategies and then almost seamlessly doing an integrated report.'
>
> Judge Mervyn King

1. Introduction

In recent years there has been an increasing trend towards the disclosure of non-financial information in annual reports, and producing a more comprehensive, 'integrated' report.

This reflects two broad lines of thinking:

- Firstly, a general concern with the role of business in society. This involves an awareness that the stakeholders in an enterprise are not merely the shareholders who provide capital, but persons contracting with the business, such as employees, suppliers and customers, as well as those with non-contractual relationships, such as local communities, non-governmental organizations and the like. The role of the state as policy-maker and regulator of the economy also warrants consideration.

  This broader viewpoint of the corporation in society implies that disclosures should be made regarding matters such as safety, health and the environment (SHE), governance and ethical matters, and societal and transformation issues (in the King IV Report this is referred to as a paradigm shift from financial capitalism to inclusive capitalism (p 4)).
- Secondly, there are qualitative issues which influence the ability of the enterprise to create value in the future. These typically relate to investment in human and other intellectual capital, development of corporate brands, effective management of risk, the quality of information technology, maintenance of the reputation of the enterprise and the like (the King IV Report highlights this as a change from short-term to long-term thinking, arising from the need to create value in a sustainable manner (p 4)).

Whereas financial reporting tends to focus on providing an historic record, non-financial disclosures relating to the items mentioned above enable users to obtain a better sense of the long-term prospects of the organization.

These fresh perspectives on corporate reporting mesh well with the concept of sustainability and the achievement of a balanced and integrated economic, social and environmental performance which is now generally referred to as the 'triple bottom line'. This leads to the notion of an integrated report, being one that deals with the business as an integrated whole in which sustainability issues form part and parcel of the way of doing business.

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The King Report deals with these issues as part of Principle 5, 'Reporting', setting out a series of recommended practices. It notes that the understanding of integrated reporting has evolved significantly since its introduction in King III and that it is an outcome of integrated thinking (p 28). The integrated report, although important, is only one of the various types of reports that a company may issue, for legal compliance purposes and/or to meet stakeholders' information needs—including the financial statements and the sustainability report.

The term 'sustainability' in the business context is generally regarded as having originated in the phrase 'sustainable development' used in the 1987 Brundtland report, as meaning 'development that meets the needs of the present without compromising the ability of future generations to meet their own needs'.

Amongst larger listed companies in South Africa, sustainability reporting has become widespread, in common with global trends—though South African companies need to consider the peculiarities of local circumstances. To some extent this was prompted by the recommendations of the second King Report that every company should report at least annually on the nature and extent of its social transformation, ethical safety, health and environmental management policies and practices (2002 Code 5.1.1). Investors are increasingly insisting on the disclosure of sustainability information.

In the foreword of the Code for Responsible Investing in South Africa, 2011 (referred to as CRISA), John Oliphant writes as follows:

> '... the launch of the Code for Responsible Investing in South Africa ("CRISA") are clear indications that ESG issues are mainstream investment considerations and not peripheral, especially at a time the world is facing serious sustainability challenges. These challenges range from the effects of the recent financial crisis, which left most pension schemes underfunded and government debts in developed markets at unsustainable levels, to socio-economic challenges and climate change which threatens our own existence as human society. This is a trend that cannot be allowed to continue. As long-term investors and fiduciaries, institutional investors have the responsibility to ensure that we invest in a way that promotes long-term sustainability.
>
> At the heart of CRISA is the recognition of the importance of integrating sustainability issues, including ESG, into long-term investment strategies. These issues become more important in a market such as ours, which is predominantly driven by a non-mandatory market-based code of governance for companies (King Report on Governance), as opposed to legislation. The institutional investor in such a set up has, by virtue of its share ownership, the ability to influence and encourage the companies in which it invests to apply sound governance principles and to care for the environment in which it operates. CRISA sets out the governance duties of institutional investors in relation to the overall governance system including engagement with companies on ESG issues ...'

Before detailed content of the integrated report can be considered, there are some general comments as to the characteristics of integrated reporting and the related sustainability disclosures which are relevant—

- Firstly, integrated sustainability reporting is likely to be far more effective if it reflects the actual way in which business is conducted; put differently, if a

CHAPTER 14

Stakeholder Relationships

I present myself to you in a form suitable to the relationship I wish to achieve with you

Luigi Pirandello

1. Introduction

Acceptance of a wide range of stakeholders, rather than simply shareholders, brings with it a need to manage these relationships. For large companies, it is no longer sufficient simply to have an employee handling investor relations, and dealing only with investors—other stakeholders such as customers, suppliers, and employees have to be considered, as well as the media. Consequently a multi-faceted approach will be needed to handle stakeholder relations. This is recognized in King IV's Principle 16, which states, under the heading of 'Stakeholder Relationships' that the governing body 'should adopt a stakeholder-inclusive approach that balances the needs, interests and expectations of material stakeholders in the best interests of the organisation over time' (King IV, p 71).

The first two recommendations in the King IV Code flowing from this are that the board should assume responsibility for the governance of stakeholder relationships, setting the direction as to how these should be approached and conducted, and that it should approve policy articulating and giving effect to this (King IV p 71, 16.1 and 2). It is important that this be comprehensively documented—communication is a two-way process and all too often organisations find themselves reacting to initiatives taken by stakeholders—for example disgruntled shareholders—and unless there are clear policies in place, the organisation's response may be uncertain and ineffective.

The King III Report made the point that stakeholder perceptions of companies result in the formation of corporate reputations—and that reputation is an important contributor to the economic value of the company (King III, 100.1). At the time of writing, matters such as the debacle around the contamination of food products produced within the Tiger Brands group, the apparent connivance between various global consulting groups and SARS, the pervasive effects of 'State capture' on state-owned entities and other corporate scandals underline the point.

2. Corporate reputation

The King IV Code states that the board should exercise ongoing oversight of stakeholder management; in particular this should result in methodologies to identify individual stakeholders and stakeholder groupings—based on the extent to which they affect or are affected by the activities, outputs and outcomes of the organisation (King IV p 71, 16.4*a* and *b*).

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This aligns with the thinking expressed in the King III Code to the effect that the gap between corporate performance and stakeholder perceptions should be managed to enhance or protect the company's reputation, and that the reputation and linkage with stakeholder relationships should be a regular board agenda item (King III Code, 8.1.1 and 2). King IV does not specifically recommend this and it is not suggested that this be dealt with at every meeting, but rather that this should appear at least once a year and be given serious attention. The extent of focus will depend on the nature of the company—it should be high in the case of a company with a high public profile (e g a national retailer) but could be much less in other cases (for example, property trusts which, while listed, have a profile that does not extend much beyond the professional investment community).

Example from practice

The 2014 annual survey of South Africa's largest companies by the Reputation Institute had Woolworths emerging as the outright winner.

The Reputation Institute's Partner for Africa, Dr Dominik Heil was quoted as saying (14 May 2014):

'The 2014 survey shows that Woolworths is in a league of its own. Its success comes in an environment in which South African corporate companies are suffering a bloodbath in their reputations. Woolworths has managed to break out of this logic because it has a sound stakeholder management strategy. It demonstrates that engaging with stakeholders is not a loss exercise. If you create value for all your stakeholders—and not just for your shareholders—and manage that well, the benefit 'pie' for everyone will grow.'

(Woolworths has remained among the top companies in the survey, although first position in the most recent (2018) survey was taken by Clover.)

3. Managing stakeholder relationships

It is clear that the actual management of stakeholder relationships is something that has to be delegated to management, and King IV states as much (King IV p 71, 16.3). Thus, management should (*a*) develop a strategy, (*b*) develop suitable policies for the management of relations with all stakeholder groupings and (*c*) establish the mechanisms and processes supporting constructive engagement between the company and its stakeholders, all subject to board oversight.

The King III Report suggested that the board should consider whether to publish its stakeholder policies and a list of stakeholder groupings (King III,101.11 and 12). This is now something which is usually dealt with in the integrated report. The Social and Ethics Committee that is required for larger companies is also obliged to monitor corporate activity dealing with a number of categories of stakeholder, in terms of Regulation 43 of the Companies Act (although the reporting is simply to shareholders at the AGM through one of the members of the committee).

CHAPTER 15

External Audit

The auditors ought to be faithful and prudent, knowing their business, and all the points and articles of the account in rents, outlays, and returns of stock.

Sir Walter of Henley *Tretyce of Husbandry* 13th Century

The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. … An audit conducted in accordance with ISAs (International Standards on Auditing) and relevant ethical requirements enables the auditor to form that opinion.

International Federation of Accountants
Objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing 2009

Open the newspapers virtually any day of the week, or google 'auditor scandal', and you will be inundated with articles describing the failure of auditors, locally and globally, to achieve the objective of their function

Neville Chester, 2018

1. Introduction

The first statute requiring external audits for joint stock companies was enacted in the mid 19th century. Since then, the nature of an audit has been refined and changed almost beyond recognition. At first, auditors checked accounting records in detail but did not verify the physical assets of a business, nor did they review management decisions. Changes in the audit process from a mechanical routine of checking the books of account, to a vital part of corporate governance, have accelerated in recent years. At the same time a massive gap has developed between the responsibilities that the auditing profession believes it has, and the expectations that a company's stakeholders have of an audit. This has been exacerbated in the last few years by a number of corporate collapses in the private sector (in South Africa, African Bank, Steinhoff and VBS Mutual Bank being prime examples) as well rampant corruption in the public sector, not least the SA Revenue Service, if the information presented to the Nugent Commissions is proven.

In its simplest terms, the purpose of an audit is to give additional credibility to the account that directors give of their stewardship. Company law requires directors to account to the shareholders in their company according to rules set out in accounting standards. The auditor's task is to audit those accounts and report to the shareholders, as well as any other third parties who rely on such accounts,

on whether they fairly present the company's results, financial position and cash flows.

Management has adapted to the complexities of modern companies with their computer systems and global reach by introducing internal controls and risk management procedures. Auditors have also adapted by focusing their attention on internal controls and risks. Instead of checking everything in the accounting records they are now able to use management systems to establish that there are no material omissions from the financial statements as well as to satisfy themselves that what has been recorded is fairly stated. To a much greater extent than before, both management and auditors have to rely on systems (almost invariably driven by computers) to ensure accurate accounting information. (The subject of IT is dealt with in greater detail in Chapter 9.)

2. Accounting standards

The 2008 Companies Act requires a company's financial statements to 'satisfy the financial reporting standards as to form and content, if any such standards are prescribed' (s 29(1)). The Act makes compliance with financial reporting standards obligatory for most companies except those that are owner-managed. The regulations under the Companies Act envisage different standards for different categories of companies—whereas listed public companies and state-owned companies must comply with International Financial Reporting Standards (IFRS), certain other companies will have to comply with IFRS for SME's and companies with a low public interest score can determine their own standard. Interim reports issued by listed public companies (which are drafted in an abbreviated form), normally comply with IFRS statement IAS 34 on Interim Financial Reporting. This standard is also the most appropriate for summarised financial statements issued by companies in terms of the Companies Act 2008.

Chapter 12 deals with the subject of financial reporting and communication, and chapter 14 deals with stakeholders' relationships in greater detail.

3. Companies requiring audits

Unlike the previous Companies Act, the 2008 Act only requires certain classes of companies to prepare audited financial statements. These are:

- public companies;
- state-owned companies (unless they have been granted exemption);
- other companies (i e private, personal liability and non-profit) that are required to do so:
  - — by their Memoranda of Incorporation; or
  - — by Regulation 28.

Regulation 28 makes the appointment of an auditor compulsory for companies that:

- hold assets in excess of R5 million in a fiduciary capacity on behalf of unrelated persons;

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CHAPTER 16

Internal Audit

Remember that even if you haven't been audited in the past, it doesn't mean you won't be in the future. And it only takes one audit to ruin your day.

Kathy Burlison

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

The Institute of Internal Auditors

1. Introduction

For many years internal auditing was a 'Cinderella' profession, working in the shadows while its more glamorous cousin, the external auditing profession, basked in the limelight. All this changed with the emergence of corporate governance as an imperative for listed companies. Suddenly, internal audit became a necessity for every listed company and the size of the internal auditing profession mushroomed. More recently, the failure of external audit to identify defective financial statements has underlined the importance of strong and independent internal audit.

There is no doubt that internal audit is an important and integral part of the corporate governance of most listed companies. This was recognised by King lll in 2009, which required companies whose directors decided that internal audit was unnecessary, to give full reasons and explain how they had obtained adequate assurance of effective governance, risk management and internal control (King III p 93). Certain companies, for instance those with activities consisting solely of passive investments, can manage satisfactorily without internal audit, but a company of any size that has manufacturing, trading or financial operations cannot be said to have good corporate governance unless it uses internal auditors. King IV, however, appears simply to assume that an internal audit function will be in place (p 69).

Internal auditing has a relatively recent history. In South Africa it came to prominence in the last third of the 20th century as a function in many large companies. To start with, its role was usually as an integral part of the system of internal control — checking clerical procedures and searching for fraud.

Internal audit has since become an essential part of corporate governance for larger and more complex companies. King lll described the key responsibilities of internal audit as assisting the board and its committees in their governance function and to carry out the following tasks at a minimum (whereas King IV does not go into detail):

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- Evaluate the company's governance processes including ethics, especially the 'tone at the top';
- Perform an objective assessment of the effectiveness of risk management and internal control;
- Analyse and evaluate business processes and associated controls;
- Provide information on instances of fraud, corruption, unethical behaviour and irregularities (King III, p 93).

These tasks should culminate in a written assessment to the board on the effectiveness of governance, risk management and internal control. Normally, this will go through the audit committee first. In addition, a specific report on internal financial controls must go to the audit committee; usually this reporting will take place at each audit committee meeting, so there will be ongoing monitoring of the adequacy of the control systems.

2. Internal audit charter

In guiding the work of internal audit, a charter should be in place, approved by the governing body (King IV, p 69, 15.49). The charter will define the role, responsibilities and authority of internal audit, as well as the internal audit standards to be adopted.

An example of an internal audit charter is set out as a Practice Note to King lll, still obtainable from the Institute of Directors' website (there is no Practice Note for King IV on this topic). Its main contents are as follows:

Purpose

This section defines the overall purpose of the internal audit function.

Authority and independence

This section describes to whom the internal audit function is responsible, how its leader (referred to in King IV as the Chief Audit Executive (CAE)) is appointed, its access to information and executives and how it is evaluated from time to time. It also makes it clear that internal audit may not perform operational duties, initiate accounting transactions or direct any employees outside the internal audit department. It makes the point that any limitation of scope must be reported to the CEO and audit committee.

Responsibilities

This section describes the scope of the duties of internal audit, confirms that the standards of the Institute of Internal Auditors must be applied and summarises the recommendations of King lll in regard to internal audit.

Operational planning.

This section describes the factors to be considered in planning and managing an internal audit function.

CHAPTER 17

Compliance

> Compliance: The process of meeting the expectations of others. More specifically, it is the process of helping professionals understand and meet the expectations of those who grant us money, pay for our services, regulate our industry, etc.
>
> Society of Corporate Compliance & Ethics, Minneapolis, USA

> Laws are rules, made by people who govern by means of organized violence, for non-compliance with which the non-complier is subjected to blows, to loss of liberty, or even to being murdered.
>
> Leo Nikolaevich Tolstoy

1. The burden of compliance

In South Africa, since January 1 2000, there have been over 750 new Acts of parliament with which everyone in the country is expected to comply. Fortunately most business people do not need a working knowledge of all these laws, but even compliance with 45 of the most widely applicable acts (pages 285–286) is challenging. And for a listed company or state-owned company, compliance with statutes and common law is not enough. International Financial Reporting Standards, JSE listings requirements and King IV add to the burden.

King IV emphasises the role of the board to ensure that the company complies with all applicable laws. It goes on to recommend that the board should also consider adherence to non-binding rules, codes (including King IV), and standards (p 63, Principle 13). The point is made that compliance with laws is not one-sided, as many laws confer rights and protection on the law-abiding (p 64, 13, 21.*a*.). To act in the best interests of a company means taking advantage of its rights as well as carrying out its obligations. The board should approve a policy that articulates and gives effect to the direction it sets in respect of compliance (p 63, 13, 19).

2. Responsibilities for compliance

The board should regularly monitor compliance with laws and other rules, codes and standards. The responsibility for compliance with laws and regulations is usually that of operating or line management. King IV emphasises this point in its Principle 13 (p 64, 13, 20): ‘the board should delegate to management the implementation and execution of effective compliance management.’

The task of monitoring compliance will vary depending on the nature of a company’s business. Some monitoring activities are closely linked with the operations (for example in a mining or industrial company) while others may be the responsibility of internal audit or compliance officers. The turmoil in the international banking industry in recent years has led to increased focus on compliance and reporting by banks to their boards and to regulators. In most companies the board receives its reports on compliance from the company secretary.

Example from practice

The Standard Bank Group Limited disclosed the following in its 2017 Integrated Report.[1]

Measuring our strategic progress

'Our strategic value drivers are the framework we apply in measuring our strategic progress. They inform our allocation of resources and guide our trade-off decisions. We have made further progress in aligning our governance, planning and reporting processes to our strategic value drivers, and will continue to refine the underlying metrics to ensure that we are measuring what matters most in delivering our group strategy.'

RISK AND CONDUCT

Our licence to operate, and our competitiveness, is a function of the trust our stakeholders have in us. Our ability to manage risk and uphold the letter and spirit of the laws, regulations, codes and standards applicable to our businesses – from regulatory capital requirements to the highest standards of ethical and responsible business practice – determines our reputation. The importance of this is growing, as financial crime and corruption become more pervasive, and the conduct of banks comes under increasing scrutiny.

WHAT SUCCESS LOOKS LIKE

- Doing the right business the right way, without exception.
- Contributing to safe financial systems in the markets in which we operate.
- No material breaches of legislation.
- No harm to our reputation.

HOW WE MEASURE OUR PROGRESS

RISK

We manage our capital levels to support business growth, maintain depositor and creditor confidence, create value for our shareholders and other stakeholders and promote regulatory compliance. Our risk measures are regulatory requirements and indicate our ability to withstand financial stress and unexpected losses, and the quality and liquidity of the assets we hold.

Our indicators

- **Common equity tier 1 ratio (CET 1):** a measure of solvency that assesses capital strength against our risk-weighted assets (RWA).
- **Liquidity coverage ratio (LCR):** measures our ability to manage a sustained outflow of client funds in an acute stress event over a 30-day period.
- **Return on risk-weighted assets (RoRWA):** the return we generate based on our average risk-weighted assets.
- **Net stable funding ratio (NSFR):** the amount of available stable funding relative to the amount of required stable funding, in accordance with Basel III.

CONDUCT

Our compliance with laws and regulations is non-negotiable. Any contravention comes at a cost in financial losses, fines or diminished reputational capital. We deal with such instances through well-developed disciplinary processes and appropriate action.

Our indicators

We are aiming to measure, understand and control risk and our conduct in even more detail. During the year, we worked to identify and develop appropriate metrics to assess our conduct and behaviours. We will continue to monitor these metrics to ensure that they enable us to track the extent to which we have embedded our desired culture and the effectiveness of our governance structures relating to conduct.

HOW WE PERFORMED

Risk

Our risk appetite measures are above our internal risk appetite targets and, where applicable, regulatory requirements.

CET 1 (Lib)
13.5%
(2016: 13.9%)
Target:
11% – 12.5%

LCR
135.1%
(2016: 117.1%)
Target: regulatory minimum of 80%

RoRWA (Lib)
3.1%
(2016: 2.7%)

NSFR
>100%
Target: regulatory minimum of 100%

Standard Bank Group Limited *2017 Integrated Report*

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[1] https://thevault.exchange/?get_group_doc=18/1524201398-SBGFY171Annualintegratedreport.pdf on Page 22.

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CHAPTER 18

Remuneration Governance

'We're overpaying him, but he's worth it.'

Samuel Goldwyn

'At the current rate of change, and given the continued widening of the economic gender gap already observed last year, it will now not be closed for another 217 years.'

The Global Gender Gap—World Economic Forum

The governing body should ensure that the organisation remunerates fairly, responsibly and transparently so as to promote the achievement of strategic objectives and positive outcomes in the short, medium and long term.

King IV principle 14

1. The importance of remuneration

No aspect of corporate governance arouses as much controversy and attention as remuneration in major companies, especially for top executives. In recent years aspects of remuneration have given rise to a flurry of new rules and legislation in developed economies as regulators scramble to respond to public concerns. There has also been increased scrutiny of how the remuneration cake is divided between employees. In particular there have been calls for disclosure of the gap between the remuneration of the median employee and that of top executives as well as the gender pay gap between men and women.

In South Africa, King lll required companies to provide annual reports explaining their remuneration policies and how they had been implemented. This was coupled with the requirement of non-binding advisory votes by shareholders on the company's remuneration policies at each annual general meeting.

King IV has now expanded the focus of remuneration governance beyond executive pay to include the whole organisation. It has also increased the requirements for reporting and for obtaining shareholders' non-binding votes. These are dealt with below at paragraph 5 'Reporting on Remuneration'.

Effective governance of remuneration enhances the value of an organisation for all its stakeholders. For this reason, King IV makes it clear that the governing body (or board) must take responsibility for the approach to remuneration throughout the organisation and should establish a policy for 'fair, responsible and transparent remuneration'. (p 64, 26 and 27). These words are important:

'Fair remuneration' for an individual should be fair relative to that of other individuals with similar skills, aptitude, application and achievement within the organisation and in similar organisations in society; it should also be fair in relation to the value created by the individual;

'Responsible remuneration' conveys a sense of the fiduciary duty of the governing body to avoid excessively high or low pay levels and to avoid policies that may be detrimental to the organisation or to society;

'Transparent remuneration' implies granting public access to details of remuneration as well as an explanation of how the remuneration is determined.

Objectives

The objective of remuneration policy is to create value for the organisation by:

(*a*) Attracting, motivating, rewarding and retaining employees;
(*b*) Encouraging the achievement of strategic objectives within the organisation's risk appetite;
(*c*) Promoting positive performance against set targets;[2]
(*d*) Encouraging an ethical culture and responsible corporate citizenship (King IV p 65, 28).

As discussed in more detail in this chapter, the remuneration policy should deal with organisation-wide remuneration, setting out the approach to ensure that the pay levels for executive management are fair in relation to other employees. It should also explain how performance measures are used to support all aspects of the organisation's strategic goals (p 65, 29).

Remuneration policies should be reported on in a remuneration report. In addition to information on the remuneration policy, King IV recommends detailed disclosures on the implementation of the remuneration policy and that companies should set out the procedures for shareholder voting on remuneration and the steps taken in response to negative votes (see paragraph 12 below). The report should explain the purpose of each of the elements of remuneration offered by the organisation and how the remuneration committee satisfies itself as to their fairness (disclosure recommendations are also discussed in Chapter 13).

2. Remuneration committee

Of all the functions of the board of directors, the function with the greatest potential for conflicts of interests is the remuneration of the directors themselves. It is for this reason that King and most other governance codes provides for a remuneration committee. The purpose of the remuneration committee is to ensure that directors are appropriately rewarded for their work in a manner that will ensure, as far as possible, the recruitment, retention and appropriate motivation of people with the skills that the company needs. It is essential that management's remuneration is structured to ensure that their actions are directed towards the long-term benefit of stakeholders.

The remuneration committee should consist of non-executive directors of whom a majority, including the chair, should be independent. Although skills in human resources management are desirable, the main requirements are broad

[2] The performance measures may include non-financial targets such as safety or sustainability goals. In this regard King IV refers to 'positive outcomes'.

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CHAPTER 19

Public Sector

'The good of the people is the chief law.'

Cicero

'It is the lesson for every South African … that this is a country governed by a constitution and law. Your first point of reference ought to be that, if you are coming into the civil service, in fact every sphere of life.'

Lungisa Fuzile[1]

1. Introduction

The public sector in South Africa is generally taken to mean the three spheres of government, national, provincial, and local (municipal), as well as entities controlled by government, such as City Power in Johannesburg. Governance is effected both by elected representatives of the relevant voters, and also by the officials appointed by them — there is thus a loose parallel with the private sector corporate model of non-executive directors (as elected representatives of the shareholders, albeit with a primary responsibility to the company) and the executives whom they appoint and over whom they have oversight.

As has been seen, much of the governance in the private sector has progressed beyond the statutory requirements of the Companies Act and other legislation and is based on global best practice, informed by the King Reports in South Africa.

By way of contrast, in the public sector, governance is very much driven by legislation and regulations. This is liable to be less effective, particularly when applied in a context where elected representatives may have little experience and limited skills. The constant failures of delivery, and the unremitting stream of qualified reports of the Auditor-General bear sad testimony to this. This is particularly ironic, given the high ideals of the South African constitution, and legislation which has much to commend it, but is often not applied as it ought to be.

Example from practice

'Auditor-general Kimi Makwetu's personnel terrorised at municipalities

Staff members have had to face a hostage situation and threats from municipal officials, says Makwetu.

It is becoming increasingly difficult for the auditor-general of SA to perform its work in some municipalities as staff members have had to face a hostage situation and threats from municipal officials and have even been shot at.

[1] *Business Day*, 28 November 2018; Mr Fuzile, former Treasury Director-General, testifying at the Zondo commission of enquiry into state capture.

These are some of the instances of intimidation auditor-general Kimi Makwetu raised in a letter to parliament's standing committee on the auditor-general. In the letter, dated October 15, Makwetu specifically details instances of intimidation at the municipalities of Emfuleni, Tshwane, Madibeng and Moretele.

Makwetu says in the letter he believes the instances of intimidation deserve national attention, even though the office of the auditor-general will still work with the local and provincial governments in question.

'These instances not only pose a threat to the life and limb of innocent professionals employed by the AGSA [auditor-general SA], but also put the broader public interest at risk,' he said.

The finances of municipalities, which are tasked with basic service delivery such as water, sewerage and electricity provisioning, have been deteriorating, with only 33 out of 257 municipalities obtaining clean audits in the 2016/2017 financial year, according to Makwetu.

…

Nthabiseng Khunou, chair of the portfolio committee, said last week that anyone found to be obstructing the work of the auditor-general should be criminally charged and face the full might of the law.

'We call on the law enforcement agencies to fully investigate sources of the threats and bring them to book.

'Parliament, provincial legislatures and municipal councils rely heavily on the audited financial statements by the AGSA in order to effectively hold the executive accountable,' Khunou said.'

Claudi Mailovich *Business Day*, 22 October 2018

While the King IV report arguably does not apply to government departments as they are not in themselves 'entities', this may be of little relevance as the principles of King IV clearly articulate what would be regarded as good practice. It is also absolutely clear that King IV will apply to public entities, whether national (e g Airports Company), provincial (e g Northern Province Housing Board) or at local government level (Cape Town Convention Centre).

In addition to King IV, public sector entities will be subject to specific laws and regulations, some of which will overlap with the principles and recommended practices of King IV, for example those designed to ensure that the governing body of the entity or arm of government comprises individuals who are independent, competent, and honest.

2. The Public Finance Management Act (PFMA)

Public Sector organisations, including the various arms of government at national and provincial level, are subject to the requirements of the Public Finance Management Act (PFMA) of 1999, which (with minor exceptions) came into effect on 1 April 2000. The PFMA is applicable to a large number of state-owned enterprises (SOEs), such as Eskom and Transnet, listed in an appendix to the Act.

CHAPTER 20

Corporate Governance in Private Businesses and Other Small Organisations

Cruel is the strife of brothers

Aristotle *The Politics*

Govern a family as you would cook a small fish — very gently

Chinese proverb

1. What's different about small businesses?

The rest of this book deals mainly with corporate governance in large organisations, usually listed companies. Although there is a greater need for good and transparent governance in such companies, there is no doubt that good governance is also important in smaller companies and organisations. In this chapter we explore the differences between the two categories, i e large and small, and set out the principles which should govern the conduct of those in charge of smaller profit-seeking and not-for-profit organisations.

The first question to consider is 'what do we mean by a small company?' And the easiest response is to describe what it is not. Public and listed companies clearly fall outside the net, as do state organisations of various kinds. In the past, the easiest way to define the type of organisation that this chapter is concerned with was to define it as 'an entity which falls outside the specific scope of the King Report'. With the issue of King lll however, this statement no longer applied as King lll and now King IV both apply to organisations of all sizes. However King IV, probably in response to the reaction of smaller organisations that it was completely unreasonable to apply all the King III principles to such organisations, introduced the concept of proportionality. This means that the application of the Practices set out in the King IV Code should allow for the size, resources, and complexity of the organisation.

In this respect, a new aspect of King IV, not part of the previous King reports, is the inclusion of 'sector supplements' which deal with specific types of organisation. This is explored in paragraph 8 below.

Close corporations versus companies

'Company' is used throughout this book to refer to corporate bodies, whether formed for profit or not. Close corporations were especially designed to provide a user-friendly vehicle for small businesses and make up the majority of such businesses in the formal sector of the South African economy. One of the objects of the 2008 Companies Act was to establish a streamlined and simplified regime for small companies that would make it unnecessary to retain the Close Corporations Act for the registration of new corporations. Chapter 2 deals with Close Corporations at greater length.

The major difference between a small and a large company is in the nature of its stakeholders; although a small business has owners, employees, customers and suppliers, in the same way as a large one, it is not responsible to members of the public as owners or potential owners. Because the relationship between a business and its owners is a peculiarly intimate one, this makes a huge difference. It means that shareholders in a small company are well known to each other and to the directors, and that changes in shareholders take place with the consent or at least with the knowledge of the other people concerned. People who know each other well do not need the rules imposed by a stock exchange that are designed to protect investors who have no personal knowledge of each other or of the company's managers and who buy and sell shares in a company without any personal contact or relationship.

Because King IV focuses on generally applicable principles, it can be applied to all organisations, no matter what size. It also applies to non-profit companies and other non-governmental organisations, even though they have their own idiosyncrasies that are discussed later in this chapter. Obviously, flexibility may be required to adapt some of the recommended practices of King IV to the circumstances of a small organisation, and the proportionality concept specifically caters for this.

The size and scale of operations of private and family enterprises are usually considerably smaller than those of listed companies. This is hardly surprising as the very origin of public companies in the 19th century was in response to the need for raising large amounts of capital for major mining or industrial ventures. While some private companies do reach a considerable size, they are the exception to the rule.

2. Corporate governance principles for small organisations

To a small business owner or manager, corporate governance may seem an unnecessary luxury. The simple battle to survive is enough for many small businessmen and women. More rules and procedures are seen as likely to add extra costs or complications and increase the risk of failure. It is a well-documented fact that the vast majority of new ventures fail. First among the reasons for failure is the difficulty of obtaining finance; next is the need to master all the different skills required by even the smallest business. Poor corporate governance is seldom seen as a reason for the failure of a small business.

For a sole trader who owns the entire business and who manages everything himself or herself, staying within the law may be sufficient, and rules of corporate governance seem irrelevant. Corporate governance (even in a rudimentary form) starts to make more sense when a business has more than one shareholder or when management is separate from ownership. In these circumstances conflicts of interest become more likely; and rules are necessary to ensure that they are properly handled.

Another complicating factor is the multi-tasking which small businesses are obliged to expect of their people. Inevitably this means that the job description

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APPENDIX 1

Draft Questionnaires for Assessing Boards, Committees and Directors

BOARD EVALUATION QUESTIONNAIRE

Indicate the extent to which you agree with the statements below by inserting, in the 'Score' column, a score from 1–5 where 1 = strongly disagree and 5 = strongly agree.

Board evaluation statements	**Score**	**Comment**
• Ethics		
– The board has established high ethical standards to which every member of the board is committed, and holds management to those standards.		
– The actions and decisions of the board take into consideration the short and long term impacts of the company's business on all its stakeholders		
• Strategy		
– The company's strategy is based on a clear vision to which the board is fully committed		
– The board as a whole contributes to the development of the company's strategy by debating management's proposal in depth to ensure that it is robust, comprehensive and forward-looking.		
– Directors have a thorough understanding of the company's business and evolving conditions in the industry, gained from both internal and external sources.		
– The board focuses on the really important issues and sets strategic priorities.		
– In considering and debating strategy, board members consider:		
· Markets, competition and the changing needs of customers		
· Technical and operational issues		
· Financial matters		
· Human resources		
· Environmental issues		
· Issues relating to communities and society		
· Legal and regulatory issues		
– Strategic plans are carefully evaluated taking into account best and worst-case scenarios and the full impact of planned change.		
– Past strategic decisions are evaluated and lessons are applied.		

Board evaluation statements	Score	Comment
• Execution		
– The board critically examines management's implementation plans and ensures adequate management, capital and other resources.		
– The board ensures that management clearly communicates its plans throughout the organisation and that staff and other stakeholders are fully motivated.		
– Appropriate milestones and performance measures are agreed with management.		
– The board receives regular reports showing progress against financial and non-financial targets.		
• Skills		
– The board ensures that the company has the necessary skills to operate the business successfully.		
– Where applicable, these skills include expertise in each of the following areas:		
· Technical/engineering		
· Marketing		
· Financial		
· Legal		
· Managerial.		
– Members of the board demonstrate a diversity of skills, experience and perspectives in the performance of their duties.		
– There is an effective system of performance management with targets linked to the company's strategy and its value drivers.		
– Management remuneration is market-related and structured to align the interests of management with those of shareholders.		
– The board regularly evaluates its own performance and that of each of its members and committees.		
– The board ensures succession planning for management and board members.		
• Mindsets		
– Whenever necessary, the board squarely confronts any issues crucial to the company's long-term survival and prosperity.		
– Executive and non-executive roles are defined so as to minimise conflicts of interest and the risk of dominance by an individual or group.		
– A forum exists where conflicts of interest can be debated and resolved.		

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APPENDIX 2

Specimen Letter of Appointment as Non-Executive Director

Agreement for the Appointment as Non-Executive Director

made between:

. . . .[Insert name of director]
Identity Number: . . . . [Insert ID of director]
Residing at . . . . [Insert director address]

(Hereinafter referred to as the 'Director')

and

. . . . [Insert company name]
Registration no: . . . . [insert company registration number]
with its registered office at. . . . . [insert company address]

(Hereinafter referred to as the 'Company')
each a 'Party' and together the 'Parties'

1. Introduction

1.1 The appointment of the Director is governed by all applicable laws and regulations, including the Companies Act and the JSE Listings requirements, and by the Memorandum of Incorporation of the Company.
1.2 The Parties record herein some additional terms and conditions that apply to the appointment of the Director to the Board.

2. Definitions and interpretation

2.1 In this Agreement, unless the context otherwise expressly requires, the following expressions shall have the following meanings:
  2.1.1 'Agreement' means this Agreement and any amendments hereto;
  2.1.2 'Appointment' means the appointment of the Director as a non-executive director to the Board, with effect from the Effective Date;
  2.1.3 'Board' means the board of directors of the Company;
  2.1.4 'Companies Act' means the Companies Act 71 of 2008;
  2.1.5 'Effective Date' means the date of Appointment, being 1 July 2018, regardless of the Signature Date;
  2.1.6 'JSE' means the Johannesburg Stock Exchange Limited;
  2.1.7 'Listing Requirements' means the Listing Requirements prescribed by the JSE from time to time;
  2.1.8 'SARS' means the South African Revenue Service; and

2.1.9 'Signature Date' means the date of signature of this Agreement by the Party signing last in time.

2.2 The headings in this Agreement are for convenience only and are not to be used in the interpretation of this Agreement.

2.2 Reference to provisions of statutes, rules or regulations shall be deemed to be references to such provisions as amended, modified or re-enacted from time to time.

2.3 To the extent that the appointment of members of the Board or members of Board committees are subject to other regulatory requirements, including the Companies Act and the JSE Limited Listings Requirements, the provisions of such regulatory requirements shall apply and shall, in the event of any discrepancy between this Agreement and the relevant regulatory requirements, prevail.

3. Appointment

3.1 The Company hereby appoints the Director, with effect from the Effective Date, in the capacity of a non-executive director.

3.2 This Agreement does not constitute a contract of employment between the Parties.

3.3 The Director confirms that the Director is aware of the following:

3.3.1 In accordance with the requirements of the Companies Act, the Director's position on the Board is subject to shareholders' approval at the first annual general meeting of the Company following the Effective Date.

3.3.2 The Memorandum of Incorporation of the Company requires all members of the Board to resign periodically, but such members may make themselves available for re-election to the Board by shareholders.

3.4 The provisions of this Agreement shall continue to apply to the Director for as long as the Director is a member of the Board.

4. Duties of director

4.1 The Director shall serve in a non-executive role.

4.2 The Director shall carry out such duties as are consistent with the Director's position as an officer of a public company, including without limitation, attending Board meetings and other meetings of the directors, as well as meetings of any committee/s of the Board on which the Director may serve from time to time.

4.3 The Director confirms that the Director is aware of the following:

4.3.1 that all members of the Board are subject to statutory and common-law duties, that the Director understands what those duties entail and that the Director shall abide by such duties;

4.3.2 that (in addition to applicable regulatory and common-law duties) the Director's Appointment and exercise of duties are subject to:

4.3.2.1 the Board Charter;

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APPENDIX 3

King IV Summary

1. Purpose of this document

This document is primarily intended to assist companies[1] with the implementation of Part 5 ('the Code') of the King IV Report on Corporate Governance for South Africa, 2016 ('King IV Report'), by categorising the information in a manner which is intended to facilitate interpretation of the information and highlight the practical implications of the Code. Please note that the information in the Code and definitions relevant thereto have in many instances been summarised, paraphrased and/or interpreted.

In addition to the information directly related to the Code, brief information on the basic underlying concepts and approaches is provided, to contextualise the implementation of the Code.

2. Background to the King IV Report2

2.1 Paradigm shifts

Paradigm shifts in the corporate world have led to crystallisation of the fundamental concepts that underlie the King IV Report. The paradigm shifts are:

1. *From financial capitalism to inclusive capitalism:*
   Inclusive capitalism takes account of the employment, transformation and provision of all sources of capital to reposition capitalism as the engine of shared prosperity
2. *From short-term capital markets to long-term capital markets:*
   Long-term capital markets take account of the need to create value in a sustainable manner. Performance in terms of all-inclusive value should be assessed over the longer-term, with a renewed focus on the unintended consequences of performance incentives
3. *From siloed reporting to integrated reporting:*
   Resources used by companies constantly interconnect and interrelate. Reporting should reflect the interconnectedness and indicate how activities affect and are affected by the six capitals[3] it uses and the triple context[4] in which it operates. ('Capitals', or the 'six capitals' refers to stocks of value on which companies depend for their success as input to their business model, and which are increased, decreased or transformed through the company's business activities and outputs.)

[1] The terms 'company' and 'board' are used in this document, rather than the terms 'organisation' and 'governing body' used in the Code.

[2] The whole of the King IV Report on Corporate Governance in South Africa, 2016 is referred to in this document as the 'King IV Report'.

[3] The six capitals are: 1. Financial capital, 2. Manufactured capital, 3. Intellectual capital, 4. Human capital, 5. Social and relationship capital, 6.Natural capital.

[4] The economy, society and the environment.

2.2 Fundamental objective and foundation stones

The content of the King IV Report is underpinned by the fundamental objective that **value creation must be accomplished in a sustainable manner**.

The '*foundation stones*' of King IV are:

1. Ethical leadership
2. The company in society
3. Corporate citizenship
4. Sustainable development
5. Stakeholder inclusivity
6. Integrated thinking
7. Integrated reporting

3. Background to the Code's principles and practices

3.1 Principles versus practices

- The first 16 principles of the Code must be applied by all companies (the 17th principle applies only to institutional investors)
- Companies are not required to apply the practices proposed in the Code
- The Code requires, however, that each company discloses the practices it applies in order to achieve the principles, whether these practices are those proposed in the Code or different practices that the company deems more appropriate for its circumstances

3.2 Apply and explain

- The Code requires that all principles are applied and that the manner in which the principles are applied (whether by implementing proposed practices or the company's own practices) be explained. The Code does not envisage that any principle (other than principle 17) will not be applicable or applied
- The term 'should' is used throughout the Code and is to be interpreted as follows:
  - — where used in principles, indicates an ideal state
  - — where used in practices, indicates a recommended course of action that is particularly suitable

3.3 Governance outcomes

The King IV Report envisages that the application of all the principles in the Code will collectively result in the achievement of **four governance outcomes**. These are:

1. Ethical culture ('*ethics*' refers to what is good and right for the self and the other)
2. Good performance ('*performance*' refers to a company's achievements relative to its strategic objectives and the outcomes of its activities in terms of its effects on capitals)

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- Companies Act, 2008
- Competition Act, 1998
- Close Corporations Act, 1984
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