

# TOPIC 1

## CORPORATE GOVERNANCE AND STATUTORY MATTERS

### Topic overview

The aim of this topic is to explain and apply corporate governance in practical situations by referring to statutory matters regarding company directors as contained in the Companies Act, No 71 of 2008, as well as the provisions of the King III Report and Code on Governance for South Africa.

**This topic is divided into the following learning units:**

Learning unit	Title
<b>1.1</b>	<b>The background to corporate governance in South Africa</b>
<b>1.2</b>	<b>Statutory matters</b>
1.2.1	Standards of directors' conduct – section 76
1.2.2	Liability of directors and prescribed officers – section 77
1.2.3	Indemnification and directors insurance – section 78
1.2.4	Audit committees – section 94
<b>1.3</b>	<b>The King III Report and Code on Governance for South Africa</b>
1.3.1	Ethical leadership and corporate citizenship
1.3.2	Boards of directors and board committees
1.3.3	Audit committees
1.3.4	The governance of risk
1.3.5	The governance of information technology
1.3.6	Compliance with laws, rules, codes and standards
1.3.7	Internal audit
1.3.8	Governing stakeholder relationships
1.3.9	Integrated reporting and disclosure
<b>1.4</b>	<b>Corporate governance – international developments</b>
1.4.1	Sarbanes-Oxley Act

## **Learning outcomes**

<b>Learning unit</b>	In this topic we focus on the following learning outcomes:	<b>Level</b>
1.1 The background to corporate governance in South Africa	<ul style="list-style-type: none"> <li>Briefly describe the background to corporate governance in South Africa.</li> </ul>	1
1.2 Statutory matters	<ul style="list-style-type: none"> <li>Explain the requirements of sections 76 to 78 and 94 of the Companies Act, No 71 of 2008, regarding the standards of directors' conduct, liability of directors and prescribed officers, indemnification and director's insurance and audit committees.</li> </ul>	2
1.3 The King III Report and Code on Governance for South Africa	<ul style="list-style-type: none"> <li>Explain and apply the significant matters covered by the King III Report.</li> </ul>	2
1.4 Corporate governance - international developments	<ul style="list-style-type: none"> <li>Briefly describe the background of the Sarbanes-Oxley Act.</li> </ul>	1

## LEARNING UNIT 1.1

### THE BACKGROUND OF CORPORATE GOVERNANCE IN SOUTH AFRICA

#### INTRODUCTION

Statements like the following have been made regarding corporate governance:

"The King Commission describes Corporate Governance simply as "the system by which companies are directed and controlled." (King, 1994)

"Governance is the process whereby people in power make decisions that create, destroy or maintain social systems." (Ramos [sa])

"Corporate governance is not a matter of right or wrong - it is more nuanced than that." (Myburgh [sa])

"Despite questions being raised about the standard of corporate governance in South Africa, 85% of respondents believed that it significantly influenced investor confidence towards a company and 68% believed it was an important contributor to an organisation's performance." (Padayachy [sa])

In this learning unit you will learn about corporate governance in South Africa, with specific reference to the King III Report and Code on Governance.

As stated in the King III Report (2009:12), the success of companies in the 21<sup>st</sup> century is bound up with three independent sub-systems – the natural environment, the social and political system and the global economy.

The success of companies therefore depends not only on their profitability, but also on the **integration** of social, environmental and economic issues which revolve around leadership, sustainability and corporate citizenship (cf. the King III Report 2009:10–11).

#### STUDY

The King III Report (2009:5–18) **(included in the Auditing: Legislation and Standards handbook)**.

Jackson & Stent (2014:4/3–4/7), Sections 1–6

Note that you should study the **King III Report** itself (included in the **Auditing: Legislation and Standards handbook**).

## ACTIVITY 1

Define good corporate governance and briefly explain in your own words why it is important to society that companies operate within a framework of good corporate governance.

## FEEDBACK ON ACTIVITY 1

References: King III Report (2009:6–14)  
Jackson & Stent (2014:4/3) introduction

Corporate governance is the system or process whereby companies are directed or controlled. It is about companies being good corporate citizens and all that this entails. Companies are an integral part of modern society and it therefore follows that healthy, honest, open, competently and responsibly controlled companies will improve the quality of modern society.

How did you find this activity? If your answer (which you provided from your own understanding) did indeed capture the facts mentioned above, then you are ready to proceed to the next section of this unit. If, however, you notice that your answer did not fully capture the information provided in the guidelines above, then you need to go back to the discussion of the term “corporate governance”.

## ACTIVITY 2

The basis of any “code” on corporate governance can be legislated (a set of rules), or voluntary (principles and practices) or a combination of both. The King III Code identifies these two bases as “comply or else” or “comply or explain” and describes a variation of the latter, i.e. “apply or explain” (Jackson & Stent, 2014:4/4).

Explain in your own words what the term “apply or explain” means. Do you think that this allows directors to avoid adhering to principles of good corporate governance?

## FEEDBACK ON ACTIVITY 2

References: King III Report (2009:6–7)  
Jackson & Stent (2014:4/5)

“Apply or explain” means that King III follows a non-legislated approach allowing for companies to explain if they choose not to apply the principles of King III if they believe that it would be in the best interest of the company.

Directors can’t avoid adhering to principles of good corporate governance, because there is a link between good governance and compliance with the law. The directors themselves have legal duties stipulated in the Companies Act, No 71 of 2008.

**Note:** The duties of directors as laid out by the Companies Act, No 71 of 2008 will be explained in more detail in learning unit 1.2.

How did you fair in this activity? It is very important for you to keep checking and comparing your answers with the guidelines provided. The format of learning in this module has been structured in an incremental manner, meaning you need to master certain basic concepts in order to be able to understand the logic of the content in subsequent topics and learning units.

Now that you are familiar with the manner in which you are encouraged to study, remember to always compare you answers with those provided after you attempted them on your own first.

## **SUMMARY**

In this learning unit you learned what good corporate governance in South Africa means, with specific reference to the King III Report and Code on Governance.

The King III Report endeavoured to be at the forefront of governance internationally (King III Report, 2009:5).

## LEARNING UNIT 1.2

### STATUTORY MATTERS

#### INTRODUCTION

"There is always a link between good governance and compliance with law. Good governance is not something that exists separately from the law and it is entirely inappropriate to unhinge governance from the law." (King [sa])

In the previous learning unit you learned what good corporate governance in South Africa means, with specific reference to the King III Report and Code on Governance.

Some of you may already have studied sections of the Companies Act, No 71 of 2008. As **directors** play a very important role in corporate governance, we want to ensure that you have sufficient background knowledge of the sections of the Companies Act specifically dealing with directors.

In this learning unit, we will take the discussion further and introduce you to sections 76, 77, 78 and 94 of the Companies Act, which deal with the standards of directors' conduct, liability of directors and prescribed officers, indemnification and directors' insurance and audit committees.

Once you have acquired this knowledge you will study the King III Report in learning unit 1.3.

#### 1.2.1 STANDARDS OF DIRECTORS' CONDUCT – SECTION 76

This section describes certain duties of directors. Note these as you make your study notes and keep them in mind when attempting to answer the activities to follow.

#### STUDY

- Companies Act, No 71 of 2008: Section 76
- Jackson & Stent (2014: 3/45–3/46)

#### 1.2.2 LIABILITY OF DIRECTORS AND PRESCRIBED OFFICERS – SECTION 77

This section deals with instances where a director and prescribed officer may be held liable for losses suffered by the company.

## STUDY

- Companies Act, No 71 of 2008: Section 77
- Jackson & Stent (2014:3/46–3/47)

### 1.2.3 INDEMNIFICATION AND DIRECTORS' INSURANCE – SECTION 78

As stated in Section 78 (2), any provision of an agreement, the Memorandum of Incorporation or rules of a company, or a resolution adopted by a company, is **void** if it directly or indirectly seeks to relieve a director of any of that director's duties. Section 78 does, however, allow certain "protection" of directors through indemnification and directors' insurance.

## STUDY

- Companies Act, No 71 of 2008: Section 78
- Jackson & Stent (2014:3/47)

## ACTIVITY 1

The King III Report (2009:21) sets out the board of directors' responsibility to provide effective leadership based on an ethical foundation. It states that deliberations, decisions and actions of directors should be based on the four ethical values of **responsibility, accountability, fairness and transparency**. It also states that directors have five moral duties, namely **conscience, inclusivity, competence, commitment and courage**.

Briefly discuss how these values and duties tie up with sections 76 to 78 of the Companies Act.

## FEEDBACK ON ACTIVITY 1

The principles highlighted above strongly relate to section 76, which states that a director should exercise his or her powers in **good faith**, in the **best interests of the company** and with reasonable **care, skill and diligence**.

The King III ethical values of **responsibility, accountability and fairness** are clearly addressed in sections 77 to 78, where liability, indemnification and directors' insurance are described.

As mentioned in activity 2 of learning unit 1.1, there is a link between good governance and compliance with the law.

Did your answer include similar facts as included in the feedback? If you still feel uncertain and cannot generate similar facts on your own, we suggest that

you go back to the beginning of learning unit 1.2 and revise the content thereof.

### 1.2.4 AUDIT COMMITTEES - SECTION 94

Section 94 states that a public company, state owned company or other company that is required by its Memorandum of Incorporation to have an audit committee, must elect an audit committee at each annual general meeting.

### STUDY

- Companies Act, No 71 of 2008: Section 94
- Jackson & Stent (2014:3/53–3/54)

### ACTIVITY 2

1. Briefly list the membership requirements for the audit committee according to section 94 by referring to what a member **must** and **must not** be.
2. Briefly describe the main duties of the audit committee according to section 94.

### FEEDBACK ON ACTIVITY 2

You will note that in activities up to now, we have provided you with detailed answers of how you should approach the answers to the activities. Now that you know what is expected of you, we expect you to compile your answers from the various sources provided and indicated in this feedback section.

- The membership requirements for the audit committee in terms of section 94 are listed in Jackson & Stent (2014:3/53) and are not repeated here.
- The main duties of the audit committee in terms of section 94 are described in Jackson & Stent (2014:3/53–3/54) and are not repeated here.

Note that the requirements for audit committees according to the King III Report are explained further in section 3.1.3 hereafter.

### SUMMARY

In this learning unit you have studied sections 76, 77, 78 and 94 of the Companies Act, which deal with the standards of directors' conduct, liability of directors and prescribed officers, indemnification and directors' insurance and audit committees.



## LEARNING UNIT 1.3

# THE KING III REPORT AND CODE ON GOVERNANCE FOR SOUTH AFRICA

## INTRODUCTION

King III consists of a **Code of Governance**, which deals with the principles; and a **Report on Governance**, which provides recommendations for best practice for each of the principles.

Although the King III Report has adopted a voluntary basis for the application of the principles of good governance, application of these principles is compulsory for public companies listed on the JSE (previously the JSE Securities Exchange and the Johannesburg Stock Exchange).

Paragraph 8.63 of the JSE listing requirements state that issuers of annual financial statements or annual reports should disclose, amongst others, the following information (JSE listing requirements 2014):

- (a)(i) a narrative statement of **how it has applied the principles set out in the King Code**, providing explanation(s) that enable(s) its shareholders to evaluate how the principles have been applied; and
- (a)(ii) a statement addressing **the extent of its application of the principles of the King Code and the reasons for each and every instance of non-application during the accounting period**. The statement must also specify whether or not the company has applied throughout the accounting period with all the provisions of the King Code and indicate for what part of the period any non-application occurred.

**The following are significant matters covered by the King III Report:**

- 1.4.1 Ethical leadership and corporate citizenship
- 1.3.2 Boards of directors and board committees
- 1.3.3 Audit committees
- 1.3.4 The governance of risk
- 1.3.5 The governance of information technology
- 1.3.6 Compliance with laws, rules, codes and standards
- 1.3.7 Internal audit
- 1.3.8 Governing stakeholder relationships
- 1.3.9 Integrated reporting and disclosure

### 1.3.1 ETHICAL LEADERSHIP AND CORPORATE CITIZENSHIP

As stated in the King III Report (2009:20), responsible leadership is about effective responsible leadership, building sustainable businesses, reflecting on the role of business in society, doing business ethically, not compromising the natural environment and embracing a shared future.

#### STUDY

- King III Report (2009:20–27)
- Jackson & Stent (2014:4/7–4/9) topic 1

#### ACTIVITY 1

List five **responsibilities of the board** with regard to ethical leadership and the corporate citizenship of a company.

#### FEEDBACK ON ACTIVITY 1

Reference: King III Report (2009:20–21)

The answer to the question is provided in the reference above, and is not repeated here.

### 1.3.2 BOARD OF DIRECTORS AND BOARD COMMITTEES

As the board of directors is responsible for the corporate governance of businesses, this is an important section of the King III Report. Familiarise yourself with the different principles that apply to the boards and directors as stated in the King III Report.

#### STUDY

- King III Report (2009:29–52)
- Jackson & Stent (2014:4/9–4/17) topic 2

Section 66(1) of the Companies Act, No 71 of 2008 requires that the business and affairs of companies must be managed by or under the direction of a **board of directors** and section 84(4)(c) provides that every public company and state-owned company must in addition appoint an **audit committee**. The King III Report also recommends that an audit committee should be appointed for companies other than public and state-owned companies.

Section 72 of the Companies Act, No 71 of 2008 allows the board of directors to appoint any number of **committees (sub committees)**, with the King III Report and JSE listing requirements specifying at least a **remuneration committee** and, if required, **nomination** and **risk committees**.

As mentioned before, section 72 allows for **any number** of board committees to be appointed, depending on the requirements of the company. The King III Report mentions the appointment of a social and ethics committee and governance, IT steering and sustainability committees. These board committees constitute an important element of the governance process.

Please take note of the tables below, which contain a summary of the recommended composition and functions of the board of directors and its main board committees. (cf. the King III Report 2009). The composition and functions of the audit committee will be explained further in section 1.3.3.

### Board of directors

<b>Chairman</b>	<ul style="list-style-type: none"> <li>• Independent non-executive director (<i>principle 2.16</i>).</li> <li>• CEO of the company should not also fulfil the role of chairman of the board (<i>principle 2.16</i>).</li> <li>• The role of the chairman should be formalised (<i>principle 2.16 point 40</i>).</li> <li>• The chairman's ability to add value, and his performance against what is expected of his role and function, should be assessed every year (<i>principle 2.16 point 41</i>).</li> </ul>
<b>Member-ship</b>	<ul style="list-style-type: none"> <li>• The board should comprise a balance of power, with a majority of non-executive directors. The majority of non-executive directors should be independent (<i>principle 2.18</i>).</li> <li>• The board, through its nomination committee, should recommend the eligibility of prospective directors (<i>principle 2.19 point 80</i>).</li> </ul>
<b>Members</b>	<ul style="list-style-type: none"> <li>• Minimum of two executive directors of which one should be the CEO and the other the director responsible for finance (<i>principle 2.18 point 73</i>).</li> <li>• At least one third of directors should rotate every year (<i>principle 2.18 point 75</i>).</li> </ul>
<b>Meetings</b>	<ul style="list-style-type: none"> <li>• Meet at least four times a year (<i>principle 2.1 point 1</i>).</li> </ul>
<b>Functions</b>	<ul style="list-style-type: none"> <li>• The board should have a charter setting out its responsibilities. The functions of the board are listed under <i>principles 2.1 to 2.17</i> of the King III Report.</li> </ul>

**Board committees**

	<b>Remuneration committee</b>	<b>Nomination committee</b>	<b>Risk committee</b>
<b>Chairman</b>	<ul style="list-style-type: none"> <li>Independent non- executive director (<i>principle 2.23 point 131</i>).</li> </ul>	<ul style="list-style-type: none"> <li>Independent non- executive director (<i>principle 2.23 point 131</i>).</li> </ul>	<ul style="list-style-type: none"> <li>Independent non- executive director (<i>principle 2.23 point 131</i>).</li> </ul>
<b>Member-ship</b>	<ul style="list-style-type: none"> <li>Majority should be non-executive directors of which majority should be independent (<i>principle 2.23 point 131</i>).</li> </ul>	<ul style="list-style-type: none"> <li>Majority should be non-executive directors of which majority should be independent (<i>principle 2.23 point 131</i>).</li> </ul>	<ul style="list-style-type: none"> <li>Executive and non- executive directors (<i>principle 4.3 point 20</i>).</li> </ul>
<b>Members</b>	<ul style="list-style-type: none"> <li>Not specified in the King III Report.</li> </ul>	<ul style="list-style-type: none"> <li>Not specified in the King III Report.</li> </ul>	<ul style="list-style-type: none"> <li>Minimum of three members (<i>principle 4.3 point 21</i>).</li> </ul>
<b>Meetings</b>	<ul style="list-style-type: none"> <li>Not specified in the King III Report.</li> </ul>	<ul style="list-style-type: none"> <li>Not specified in the King III Report.</li> </ul>	<ul style="list-style-type: none"> <li>Meet at least twice a year (<i>principle 4.3 point 22</i>).</li> </ul>
<b>Functions</b>	<ul style="list-style-type: none"> <li>Should assist the board in setting and administering remuneration policies (<i>principle 2.25 point 150</i>).</li> </ul>	<ul style="list-style-type: none"> <li>Should assist with the process of identifying suitable members of the board (<i>principle 2.19 point 80</i>).</li> </ul>	<ul style="list-style-type: none"> <li>Should consider the risk management policy and plan and monitor the risk management process (<i>principle 4.3 point 16</i>).</li> </ul>

**ACTIVITY 2**

The board should elect a chairman who is an independent non-executive director. Explain what an **independent non-executive** director is.

**FEEDBACK ON ACTIVITY 2**

Reference: King III Report (2009:38–39) point 65–67

The concept “independent non-executive director” is explained in detail in the King III Report and is not repeated here.

In the exam you should be able to identify whether a director will be seen as independent based on the information that will be given in a scenario.

### ACTIVITY 3

The collective responsibilities of management vest in the chief executive officer (CEO). List the CEO's **main functions**.

### FEEDBACK ON ACTIVITY 3

Reference: King III Report (2009:37–38) point 60

The main functions of the CEO are set out in the King III Report and are not repeated here.

### ACTIVITY 4

Why should the CEO not fulfil the role of the chairman of the board?

### FEEDBACK ON ACTIVITY 4

Reference: King III Report (2009:37) principle 2.17 point 59 and principle 2.16

- Given the strategic and operational role of the CEO, and to prevent too much power vesting in one person, this appointment should be separate from that of the chairman of the board.
- The chairman should be an independent non-executive director. Normally, the CEO is an executive director.

### ACTIVITY 5

The board should delegate certain functions to well-structured committees. Are the chairman of the board and the CEO allowed to be **members** of the following committees in terms of the principles of the King III Report?

1. Audit committee
2. Remuneration committee
3. Nomination committee
4. Risk committee

### FEEDBACK ON ACTIVITY 5

Reference: King III Report (2009:46)

Committee	Chairman	CEO
Audit committee	No (principle 3.2 point 11)	No (principle 3.2 point 9)

Remuneration committee	Yes (principle 2.23 point 131)	No (principle 2.17 point 57)
Nomination committee	Yes (principle 2.23 point 131)	No (principle 2.17 point 57)
Risk committee	Yes (principle 4.3 point 20)	Yes (principle 4.3 point 20)

## ACTIVITY 6

Recently whilst scanning through the annual report of Stadium Ltd, a company listed on the JSE, you came across the company's schedule of directors and committees.

These appeared as follows:

### 1. Board of directors

Chief executive officer	- Donald Winthrop
Managing director - Administration	- Charles Tree
Financial director	- Monty Mann
Operations director	- Christo Wells
Human resources director	- Jerry German
Marketing director	- Koos Katswinkel
Non-executive director	- Caz Kallim
Independent non-executive director	- Mary Maswai

The company has not appointed a chairman. The most senior director who arrives at the directors' meeting acts as chairman.

### 2. Committees

2.1 Directors' Nomination Committee	- Donald Winthrop (chairman)
	- Charles Tree

This committee makes recommendations to the shareholders regarding who should be appointed as directors. If the two directors on the committee disagree, Donald Winthrop has the casting vote.

2.2 Remuneration committee	- Donald Winthrop (chairman)
	- Monty Mann
	- Koos Katswinkel

### 2.3 Audit committee

- Monty Mann (chairman)
- Christo Wells
- Mitchell Street (Internal Audit manager)
- External Audit
- Fred Carver (financial manager)

All committees meet as and when required. The board meets every six months.

### 3. Risk committee

The risk committee was disbanded at the beginning of the year. The directors know the business and the risks involved.

## REQUIRED

Comment on the information presented above in relation to the requirements of the King III report.

## FEEDBACK ON ACTIVITY 6

Stadium Ltd's adherence to the King III Report appears to be less than adequate.

### 1. Board of Directors

Reference: King III Report (2009:34–40)

- 1.1 The board does not contain a balance of executive and non-executive directors – six executive directors, one non-executive director and one independent non-executive director. Two non-executive directors, only one of which is independent, are hardly likely to bring any independent influence to the board.
- 1.2 The company has no chairman. King III recommends that the board should elect a chairman who is an independent, non-executive director.
- 1.3 The board of directors is the most important component of corporate governance and important decisions must be taken at board meetings. This requires that the meetings be knowledgeably and efficiently run. This requires careful preparation for the meeting. At present this does not take place and the meeting is simply run by the most senior director who arrives at the meeting. This also suggests that not all directors arrive for meetings.
- 1.4 The board should meet at least 4 times a year. At present the board meets only every six months.

## **2. Board committees**

Reference: King III Report (2009:40–52)

- 2.1 King III recommends that a company such as Stadium Ltd should have a nominations committee (which may be called the directors' appointment committee). This committee should be chaired by an independent non-executive director (for example the chairman of the board) and the majority of members should be non-executive directors, the majority of whom should be independent.
- 2.2 The recommendations for appointment of directors should be made by the Board as a whole and not a select committee. A nominations committee should merely assist in the process.
- 2.3 The remuneration committee should be chaired by an independent non-executive director and the majority of the members should be independent non-executive directors. At present this committee has no independent non-executive directors.
- 2.4 In terms of King III, the audit committee should be chaired by an independent non-executive director, which Monty Mann is not, and it should be made up of independent non-executive members, which it is not.
- 2.5 Neither Fred Carver, the financial manager, nor Mitchell Street, the internal audit manager, nor the external auditors should be committee members. These three should work closely with the committee at various times but they should not form part of the committee.
- 2.6 All committees should schedule meetings properly and should meet a stipulated minimum number of times, not just on a random "as and when required" basis.

## **3. Risk committee**

Reference: King III Report (2009:46)

- 3.1 Risk is an ever present factor in any large company, and the nature of risks changes. It is unrealistic for Stadium Ltd to think otherwise and it is irresponsible to disband the risk committee because the directors "know the business and the risks involved".

## **4. General**

- 4.1 On balance this company appears to be dominated by the CEO, Donald Winthrop.

**Source:** *Graded Questions on Auditing 2015* (Gowar & Jackson 2014:29) – adapted.

### **1.3.3 AUDIT COMMITTEES**

As mentioned in section 1.2.2 before, the Companies Act, No 71 of 2008: section 94 requires of a public or state owned company to appoint an audit



committee as well as a board of directors. The King III Report also recommends that an audit committee should be appointed for companies other than public and state-owned companies.

## STUDY

- King III Report (2009:56-68)
- Jackson & Stent (2014: 4/17–4/21) topic 3

The table below provides a summary of the composition and functions of an audit committee:

	<b>Audit committee</b>
<b>Chairman</b>	<ul style="list-style-type: none"> <li>• Independent non-executive director (<i>principle 3.3</i>).</li> <li>• The chairman of the board should not be the chairman or member of the audit committee (<i>principle 3.2 point 11</i>).</li> </ul>
<b>Membership</b>	<ul style="list-style-type: none"> <li>• All members should be independent non-executive directors (<i>principle 3.2 point 9</i>).</li> </ul>
<b>Members</b>	<ul style="list-style-type: none"> <li>• Minimum of three members (<i>principle 3.2 point 10</i>).</li> </ul>
<b>Meetings</b>	<ul style="list-style-type: none"> <li>• Meet at least twice a year (<i>principle 3.1 point 7</i>).</li> <li>• Should meet with internal and external auditors at least once a year without management being present (<i>principle 3.1 point 8</i>).</li> </ul>
<b>Functions</b>	<ul style="list-style-type: none"> <li>• Should oversee integrated reporting (<i>principle 3.4</i>).</li> <li>• Should ensure that a combined assurance model is applied (<i>principle 3.5</i>).</li> <li>• Should satisfy itself of the expertise, resources and experience of the company's finance function (<i>principle 3.6</i>).</li> <li>• Should oversee internal audit (<i>principle 3.7</i>).</li> <li>• Should be an integral component of the risk management process (<i>principle 3.8</i>).</li> <li>• Should recommend the appointment of the external auditor and oversee the external audit process (<i>principle 3.9</i>).</li> <li>• Should report to the board and shareholders on how it has discharged its duties (<i>principle 3.10</i>).</li> </ul>

## ACTIVITY 7

The following is a summary of the composition and certain functions of the audit committee of Mineco Ltd, a JSE listed company in the South African mining sector.

### Audit Committee

- |               |   |                                                   |
|---------------|---|---------------------------------------------------|
| Violet Mguni  | - | Operations director                               |
| William Smith | - | Government official (only attends board meetings) |

Bob Cilliers - Financial director

The audit committee meets annually. The audit committee evaluates the board's performance. During the recent meeting of the audit committee, it was decided that Mineco Ltd would acquire shares in Africa Coal, a coal mining company listed on the JSE. A detailed analysis of the coal-mining sector supported this decision.

## REQUIRED

Comment on the information presented in terms of the requirements of the King III Report.

## FEEDBACK ON ACTIVITY 7

Reference: King III Report (2009:56–59)

1. In terms of the King III Report, the audit committee should comprise of at least three members. Mineco Ltd has three members and complies with the King III Report.
2. All members should be independent non-executive directors. Two members of the committee are not independent non-executive directors, as they are involved in the day-to-day running of the business.
3. The audit committee should meet as often as necessary, but at least twice a year. Mineco Ltd only meets annually and does not comply.
4. The board should be evaluated by the chairman or by an independent party, not by the audit committee.
5. As part of risk management, the audit committee cannot make decisions on the acquisition of shares in Africa Coal. This should be the responsibility of the board (with the approval of shareholders).

**Source:** Unisa – TOE412S/105/2011 – adapted

### 1.3.4 THE GOVERNANCE OF RISK

According to the King III Report (2009:73), the essential focus of the **governance** of risk is that “the board should exercise leadership to prevent risk management from becoming a series of activities that are detached from the realities of the company’s business.” Risk is positioned as a cornerstone of corporate governance and it is emphasized that it is the board’s responsibility to ensure that it is satisfied with the management of risk.

## STUDY

- Reference: King III Report (2009:73–80)
- Jackson & Stent (2014:4/21–4/26) topic 4

**Who is responsible for what?** The table below sets out the responsibilities for the governance of risk.

WHAT	WHO
Governance of risk	The board ( <i>principle 4.1</i> ).
Design, implementing and monitoring the risk management plan	The board should delegate to management ( <i>principle 4.4</i> ).
Monitor the risk management process	The board, risk committee, audit committee ( <i>principle 4.3 point 19</i> ).
Performing an objective assessment of the effectiveness of risk management	Internal audit ( <i>principle 7.1 point 2</i> ).

## ACTIVITY 8

Explain the responsibility of **management** and the **CEO** in the risk management process?

## FEEDBACK ON ACTIVITY 8

Reference: King III Report (2009:75–76)

The responsibility of **management** and the **CEO** in the risk management process is explained under points 24 to 30 in the King III Report and is not repeated here.

## 1.3.5 THE GOVERNANCE OF INFORMATION TECHNOLOGY

The governance of information technology is dealt with in detail in the King III Report.

## STUDY

- King III Report (2009:82–87)
- Jackson & Stent (2014: 4/26–4/28) topic 5

## ACTIVITY 9

Chapter 4 of the King III Report deals with the governance of risk. Explain the role that information technology plays in the company's risk management.

## FEEDBACK ON ACTIVITY 9

Reference: King III Report (2009:85; 87)

The role that information technology plays in the company's risk management is explained under principles 5.5 and 5.7 in the King III Report and is not repeated here.

### **1.3.6 COMPLIANCE WITH LAWS, RULES, CODES AND STANDARDS**

The board should ensure that the company complies with applicable laws, rules, codes and standards. The board should monitor this and disclose details in the integrated report (King III Report, 2009:89).

#### **STUDY**

- King III Report (2009:89–91)
- Jackson & Stent (2014:4/29–4/30) topic 6

### **ACTIVITY 10**

Explain the main functions of the **board**, **management** and the **compliance officer** with regards to compliance with laws, rules, codes and standards according to the King III Report.

### **FEEDBACK ON ACTIVITY 10**

Reference: King III Report (2009:89–91)

The functions of the board, management and the compliance officer with regard to compliance with laws, rules, codes and standards, are explained in the King III Report, 2009:89–91 and are not repeated here.

**Note:** The ultimate responsibility for complying with laws, rules, codes and standards lies with the board. The board's right to delegate the implementation of a compliance framework and process to management and to appoint a compliance officer falls within the framework of appointing board committees, as explained in section 1.3.2.

### **1.3.7 INTERNAL AUDIT**

#### **STUDY**

- King III Report, 2009:93–98
- Jackson & Stent (2014:4/30–4/32) topic 7

## ACTIVITY 11

Explain in your own words what the term “risk based audit approach” means in the context of the King III requirements for internal audit.

## FEEDBACK ON ACTIVITY 11

Reference: Jackson & Stent (2014:4/6)

The risk-based audit approach places emphasis on internal audit understanding the risks associated with the strategic direction of the company and determining whether internal controls, processes and procedures, adequately address these risks.

## ACTIVITY 12

Speed (Pty) Ltd, a large retailer of sporting goods with outlets in all major towns and cities in South Africa, has recently established an audit committee and internal audit department, headed up by Josh Kronveld, a chartered accountant, and staffed by three suitably qualified internal auditors. The department reports to the audit committee. Josh Kronveld has received numerous requests for his department’s services, which are listed below:

1. The manager of the company’s largest retail outlet requested that one of the internal auditors be seconded to the outlet for a period of three months, as the outlet’s accountant was to be away on maternity leave.
2. The financial director has requested internal audit to install the software for a new wage application, and control the conversion to the new system. Internal audit has the necessary expertise.
3. The warehousing manager has requested that internal audit evaluate the operational efficiency of the company’s distribution system for the dispatch of goods from the central warehouse to the outlets.
4. The head office financial manager has requested internal audit to perform a surprise physical verification of the existence of fixed assets at two other large retail outlets, e.g. shop fittings, tills, furniture, office equipment including computer hardware.
5. The financial director has requested that internal audit perform an in depth analysis of the monthly trading returns submitted by the outlets to head office.
6. The managing director has requested that Josh Kronveld make a presentation to the Board on the laws and regulations that govern the company and its operations, highlighting any areas where laws or regulations are not being complied with.

7. The external auditors have requested that the members of the internal audit department, attend the financial year-end inventory counts on their behalf, at four of the company's retail outlets. The external auditors will have their own teams at the other outlets.
8. The human resources manager has requested that Josh Kronveld be present at the annual wage negotiations to ensure that company policy and labour law requirements are adhered to.
9. The financial manager has requested that in future, Josh Kronveld authorize the write-off of bad debts at the end of each month after investigation of the debtors' circumstances.
10. The chairman of the social and ethics committee has asked Josh Kronveld if his three qualified internal auditors could assist the local community college by lecturing on the college's evening auditing courses.

### **Required**

Indicate, giving reasons, how Josh Kronveld should respond to each of these requests.

## **FEEDBACK ON ACTIVITY 12**

General: Josh Kronveld should inform all those seeking his department's services that he reports to the audit committee and any assignments undertaken will be discussed with it.

1. This request should be politely refused. Internal audit is essentially an independent monitoring and assurance function, reporting to the audit committee; it should neither perform any operational duties, nor supervise or direct staff not employed by internal audit. To fulfil the role of outlet accountant would result in both of the above. In addition the future relationship between the retail outlet and the internal audit department would not be independent.
2. This request should also be politely refused.
  - 2.1 As internal audit has the expertise, they may offer to evaluate the software and the conversion at any point in time and report their findings, but should not undertake operational responsibility for "installing" systems. (In effect, they should be part of the post-implementation review and probably should have been involved in evaluating the suitability of the new wage application software.)
  - 2.2 In future, internal audit may be called upon to give an independent assessment of the new application; they cannot also be the installers.

3. This is a perfectly valid request as it fits into the scope of internal audit's functions. These include performing assessments of internal control and evaluating business processes.
- 3.1 Provided at least one member of the team understands the logistics of retail distribution, the assignment may be accepted.
4. As the verification is to be on a surprise basis it would appear that some kind of fraud or misappropriation of assets is suspected.
- 4.1 If this is suspected, internal audit could justifiably be involved as one of its basic functions is to provide an independent source of information regarding instances of fraud, corruption etc, at the company.
- 4.2 If this is just an arbitrary request from the financial manager (no suspicion of theft or fraud) Josh Kronveld should not involve his department as internal audit is not responsible for routine asset safeguarding procedures.
- 4.3 Clearly this request is also not part of a planned internal audit risk evaluation relating to fixed assets.
5. Josh Kronveld will have to establish the intention of this request. If the financial director intends that this in-depth analysis becomes a regular monthly procedure, it becomes an operational duty and should not be taken on by internal audit.
- 5.1 However, if this is in effect a once off evaluation of the trading data to evaluate its validity, accuracy and completeness, or for example to specifically identify fraudulent practice at an outlet(s), the assignment could be undertaken.
6. This is an acceptable request. Part of internal audit's scope of work should be to assist in the monitoring of the company's compliance with laws and regulations. This assignment requires internal audit to evaluate the company's responses to the risk of failing to comply with laws and regulations.
7. Co-operation between internal audit and external audit is to be encouraged and Josh Kronveld should make every attempt to accommodate the request.
8. It is questionable whether the presence of Josh Kronveld at these negotiations would be of any value. The human resources director should be fully familiar with company policy, and the adherence to labour law requirements is best left to the judgement of lawyers.
- 8.1 In addition, a (presumably) annual wage negotiation is really an operational activity in which Josh Kronveld should not be involved.

Josh Kronveld should probably explain to the HR manager that he is not likely to add much value to the negotiations.

9. This request should be declined. Internal audit should not approve any accounting transactions. This is an operational activity. The only thing that internal audit could do, would be to monitor (from time to time) that the correct procedures (controls) are exercised in the writing off of bad debts particularly if there is a perceived risk that controls and procedures are not being followed.
10. This request should be accepted as a service to the local community. It will enhance the image of the company and make a positive contribution to the community which is one of the company's stakeholders.

**Source:** *Graded Questions on Auditing 2015 (Gowar & Jackson 2014:40) – adapted*

### **1.3.8 GOVERNING STAKEHOLDER RELATIONSHIPS**

The King III Report emphasises a “stakeholder inclusive” approach to corporate governance.

## **STUDY**

- King III Report (2009:100–106)
- Jackson & Stent (2014:4/32–4/37) topic 8

## **ACTIVITY 13**

- 1 Define the term “stakeholder” according to the King III Report.
- 2 Do you regard yourself as a stakeholder of your local municipality? Do you think that they should adhere to the principles of the King III Report with regard to stakeholder management? If so, how do your local municipality's operations affect you?

## **FEEDBACK ON ACTIVITY 13**

Reference: King III Report (2009:100)

1. The term “stakeholder” is defined in the King III Report 2009:100 under point 6 and is not repeated here.
2. You are indeed a stakeholder of your local municipality, to which you pay rates and taxes every month. The Public Finance Management Act (PFMA) does not make the application of the King III Report compulsory



for government institutions, but the same principles of good corporate governance are embodied in the Act.

**Sec 2 of the PFMA** —The object of this Act is to secure transparency, accountability and sound management of the revenue, expenditure, assets and liabilities of the institutions to which this Act applies.

Your local municipality's operations affect you in many ways, one of which is service delivery.

### 1.3.9 INTEGRATED REPORTING AND DISCLOSURE STUDY

- King III Report (2009:108–111)
- Jackson & Stent (2014:4/37–38) topic 9

Note the following from the study information:

- King III's integrated reporting is often referred to as “triple bottom line” reporting.

✿ **Triple bottom line** – A company should report on its performance with regard to **economic**, **social** and **environmental** issues.

## ACTIVITY 14

Treelines Ltd is a large forestry company which grows and harvests trees and transports them to its mills, where the timber is pulped (an operation which uses a great deal of water and produces unusable waste) for the manufacture of pulp-based products. Demand for pulp-based products is declining world-wide, but demand for other timber products is stable.

The company's forests are spread over numerous regions of the country and the majority are in remote areas. A key element of the location of forests for both re-planting and new forests is the level of local rainfall as forests are not irrigated.

Treelines Ltd employs a reasonably large work force at its forest locations, ranging from unskilled to skilled logging machine operators, all of whom are vital to the operation. It also has a large administrative, financial, marketing and support staff of mixed gender and race at its head office.

The board of Treelines Ltd follows sound corporate governance practices regarding the way it conducts its business and reports to its stakeholders. Integrated sustainability reporting and disclosure are regarded as important.

**YOU ARE REQUIRED TO:**

1. Discuss how frequently a company like Treelines Ltd should report to its stakeholders on sustainability and other issues.
2. Identify the main stakeholders, other than shareholders, with whom Treelines Ltd should be “building relationships and promoting respect” and indicate briefly for each why you consider them to be stakeholders.

**FEEDBACK ON ACTIVITY 14**

1. Effective reporting should take place at least once a year, but there is no fixed number of times that it should take place. The objective is to keep all stakeholders informed in a manner that satisfies the needs of each stakeholder group.
2. Treeline Ltd's main stakeholders are:

Reference: King III Report (2009:100)

- 2.1 **Suppliers** of goods and services without whom the company cannot operate effectively.
- 2.2 **Creditors** arising from the supply of goods, services and finance, for example loan providers. These parties are owed money and therefore have a direct stake in the company.
- 2.3 **Employees** at all levels and in all activities, skilled, unskilled and administrative.
- 2.4 **Government** and important parties in respect of other legislation, for example the granting of forestry licenses.
- 2.5 **External auditors** who require co-operation and respect to fulfil their function.
- 2.6 **Customers** who may range from individual to large corporations to government and who are the lifeblood of the company.
- 2.7 **Industry at large** - Treelines Ltd does not operate within a vacuum. It is part of the greater economic community and the forestry/milling/pulp/paper industry specifically. Co-operation and participation are key to sustainability of the industry as a whole.
- 2.8 **Local communities** - Companies are part of a wider society and as in the case of Treelines Ltd, numerous local communities. The company depends on these communities and vice versa.
- 2.9 **Media** - Financial, industrial and human interest journalists write about the company and can enhance or damage a company's reputation and its image as a good corporate citizen.
- 2.10 **Regulators** – Treelines Ltd will probably be regulated by a number of bodies that require compliance with rules, regulations or a code, for example the Forest Stewardship Council regulations and code. A sound working relationship between the company and regulator must be cultivated.

*Source: Graded Questions on Auditing 2013 (Gowar & Jackson 2012:27) – adapted.*

## SUMMARY

In this learning unit we explained and applied the provisions of the King III Report and Code of Governance for South Africa.

### 1.4 CORPORATE GOVERNANCE – INTERNATIONAL DEVELOPMENTS

#### INTRODUCTION

The King III Report and Code on governance as well as the Companies Act, No 71 of 2008 are providing rules, laws, principles and recommendations to companies in South Africa to ensure that they adhere to good corporate governance.

There are similar laws and codes governing the rest of the world. One of these is the Sarbanes-Oxley Act which we will be looking at in a bit more detail.

##### 1.4.1 SARBANES-OXLEY ACT

The Sarbanes-Oxley Act ("SOX") came into force in July 2002 and introduced major changes to the regulation of corporate governance and financial practice. It is named after US Senator Paul Sarbanes and US Representative Michael Oxley, who were its main architects, and it set a number of non-negotiable deadlines for compliance for all United States (US) public company boards, management and public accounting firms. (Wikipedia, [sa])

As a result of SOX, top management must individually certify the accuracy of financial information. In addition, penalties for fraudulent financial activity are much more severe. Also, SOX increased the oversight role of boards of directors and the independence of the outside auditors who review the accuracy of corporate financial statements. (Wikipedia, [sa])

The bill, which contains eleven sections, was enacted as a reaction to a number of major corporate and accounting scandals, including Enron and Worldcom.

These sections of the bill covers responsibilities of a public corporation's board of directors, adds criminal penalties for certain misconduct, and required the Securities and Exchange Commission to create regulations to define how public corporations are to comply with the law. (Wikipedia, [sa])

In response to the perception that stricter financial governance laws are needed, SOX-type regulations were subsequently enacted in Canada (2002), Germany (2002), South Africa (2002), France (2003), Australia (2004), India (2005), Japan (2006), Italy (2006), Israel and Turkey. (Wikipedia, [sa])

Please follow the following link to a video of a summary of SOX.

[Sarbanes-Oxley Act Of 2002 – SOX - Video | Investopedia](#)

## ACTIVITY 1

What is the main purpose of the Sarbanes-Oxley Act (“SOX”)?

## FEEDBACK ON ACTIVITY 1

The main purpose of SOX is to protect shareholders from fraudulent representations in corporate financial statements. Investors need to know that the financial information they rely on is truthful, and that an independent third party has verified its accuracy.

## SUMMARY

In this learning unit we described the background of the Sarbanes-Oxley Act as a regulatory measure of corporate governance internationally.

## CONCLUSION

In this topic, **corporate governance and statutory matters**, we explained and applied corporate governance principles by referring to the background of corporate governance and statutory matters regarding company directors, as well as the provisions of the King Code on Governance. We also touched on the background and main purpose of the Sarbanes-Oxley Act.

In the next topic we will explain and apply the theory of internal control as an important aspect of corporate governance.