



# Final King III synopsis

September 2009



# Introduction

The Code of Governance Principles for South Africa 2009 – colloquially known as King III – was released by the Institute of Directors (IoD) in February 2009 for a period of public comment and debate with the revised and final version being released in September 2009.

The update to the King II Report issued in 2002, came about due to changes to many pieces of South African legislation, specifically the Companies Act, more stringent legislation in certain jurisdiction, and changes in global corporate governance standards and expectations of stakeholders.

The Code strengthens previous requirements, clarifies certain issues, expands on existing recommendations and introduces new concepts and recommendations. It ensures that it is aligned to the new and impending Companies Act and attempts to differentiate between what is a legal requirement with the words “must” and what is a recommendation with the word “should”.

It has attempted to move to a more principle based approach that can be applied by any organisation – private or public sector; listed or owner managed – and hence is applicable to all entities.

The “comply or explain” principle has been changed to the “apply or explain” principle: essentially there has been no fundamental change in the approach to governance, ie, there are many different ways to implement good governance principles and the view from the King Committee is that a “comply or else” regime should not be implemented in South Africa.

This synopsis highlights some of the key requirements, major changes to the King II Report and gives some rationale for the requirements put in place. We do however recommend that all directors read the full report to ensure they are aware of and understand all the issues and requirements.



# Ethical leadership and corporate citizenship

## Key requirements

- ▶ The board should ensure that the company is and is seen to be a responsible corporate citizen through the development and implementation of strategies and policies in relation to economic, social and environmental impacts.
- ▶ Leadership should be effective and based on an ethical foundation.
- ▶ The board should ensure that management cultivates a culture of ethical conduct through the creation of an ethics risk profile, the establishment of a code of conduct, through the integration of ethics into all company practices, procedures, policies and conduct and through the assessment, monitoring, reporting and disclosure of the company's ethics performance.
- ▶ The assurance of the company's ethics performance supported by an assurance statement in the integrated report is recommended.

## Key changes from King II

- ▶ The whole chapter is new and although the concept of organisational integrity was included in the previous report these requirements are essentially new concepts.

## Rationale

One of the key concepts of the report is sustainability. In order for sustainability to become integrated into the company, effective leadership is required. As such the board is to be responsible for the company's "sustainable development" and as a result, an entire chapter has been dedicated to this notion i.e. corporate citizenship and the need for effective ethical leadership in this regard.

# Boards and directors

## Key requirements

---

- ▶ All companies should be headed by a unitary board comprised of majority of non-executive directors.
- ▶ There should be a minimum of two executive directors on the board - the Chief Executive Officer (CEO) and the director responsible for the finance function.
- ▶ The board chairman should be an independent non-executive director.
- ▶ The board should appoint the CEO, who should be separate from the chairman.
- ▶ The board should meet as often as required to fulfil their duties, preferably at least four times per annum.
- ▶ The board should appreciate that sustainability is not separate from strategy, risk and performance and should link long term sustainability to strategy to create business opportunities.
- ▶ The board should ensure an effective risk-based internal audit and the integrity of the integrated report.
- ▶ The board should ensure that there is transparent and effective communication with stakeholders on both positive and negative aspects of the business.
- ▶ The board should report on the effectiveness of the company's system of internal controls in the integrated report.
- ▶ The following should be disclosed in the integrated report:
  - ▶ The board and board committee's composition, the number of meetings held, attendance and activities
  - ▶ The length of service and age of directors
  - ▶ Significant directorships of each board member
  - ▶ The reasons for the cessation of appointment of directors
  - ▶ The education, qualification and experience of directors
  - ▶ Any actual or potential connections or exposure
- ▶ Whether supervising of management is required in which case retention of board experience should be called for.
- ▶ The board should appoint an audit, risk, and remuneration and nomination committee.
- ▶ Board committees, other than the risk committee, should comprise only of board members and should have a majority of non-executive directors. The majority of these non-executive directors should be independent. Other than the executive committee which is usually chaired by the CEO, all committees should be chaired by an independent non-executive director.
- ▶ The performance of the board, its committees and individual directors should be assessed annually and the results thereof should be disclosed in the integrated report, along with actions plans to be implemented, if any.
- ▶ A policy to pay salaries on average above the median requires special justification.

## Key changes from King II

---

- ▶ The majority of non-executive directors should be independent.
- ▶ Non-executive directors should not receive share options.
- ▶ The chairman and non-executive directors should not receive incentive awards geared to the share price or corporate performance.
- ▶ The remuneration policy should be approved by shareholders at the annual general meeting.
- ▶ The chairman of the board should be independent and free of conflicts of interest on appointment. Failing which, the board should consider appointing a lead independent non-executive director.
- ▶ Changes have been made to the definitions of non-executive directors and independent directors as follows:

### Non-executive Director

An individual not involved in the management of the company. An individual in the full-time employment of the holding company is also considered to be a non-executive director of a subsidiary company unless the individual, by his conduct or executive authority, is involved in the day-to-day management of the subsidiary.

### Independent Non-executive Director

A non-executive director who:

- ▶ Is not a representative of a major shareholder who can control or significantly influence management or the board
- ▶ Does not have a material direct or indirect interest in the company/group which:
  - ▶ Is greater than 5% of the group's total number of shares in issue
  - ▶ Is less than 5% of the group's total number of shares in issue, but is material to his/her personal wealth
- ▶ Has not been employed by the group or appointed as designated auditor or partner in the group's external audit firm, or senior legal adviser in the previous 3 financial years
- ▶ Is not related (immediate family) to someone who has been employed by the group in an executive capacity in the previous 3 financial years
- ▶ Is not a professional advisor to the group
- ▶ Is free from any other business or relationship that could be a conflict, such as being a director of a material customer of or supplier to the company
- ▶ Does not receive remuneration based on the company's performance

- ▶ The memorandum of incorporation should allow the board to remove any director including executive directors.
- ▶ Adopting and implementing policies and procedures of the holding company in the operations of the subsidiary company should be a matter for the board of the subsidiary company to consider and approve, if the subsidiary company's board considers it appropriate. The subsidiary company should disclose this adoption and implementation in its integrated report.
- ▶ The retired CEO should not become chairman of the board of the same company until three years have passed since the end of his/her tenure as an executive director and an assessment of his/her independence has been performed.
- ▶ The remuneration of each individual director and the three most highly paid employees who are not directors of the company should be disclosed.
- ▶ Every year, the chairman and the board should evaluate the independence of independent non-executive directors. The classification of directors

in the integrated report as independent should be done on the basis of this assessment.

- ▶ If an independent non-executive director has served on the board for more than nine years, the board should assess if his/her independence has been impaired. If not, a statement that the independent director's independence of character and judgement has not been affected or impaired should be included in the integrated report.
- ▶ The integrated report should disclose any external advisers who regularly attend or are invited to attend committee meetings.

### Rationale

Many of these requirements are a continuation from King II, with at times more stringent or updated requirements and expansion in certain areas. The themes are however consistent. The major area of change, after criticism of the King II Report and media and press coverage of the issue, is a major strengthening of the remuneration oversight requirements.



# Audit committees

## Key requirements

---

- ▶ The board should ensure that an effective and independent audit committee consisting of at least three members is established that complies with the Companies Act requirements in terms of appointment and membership.
- ▶ The audit committee should be chaired by an independent non-executive director and not the board chairman.
- ▶ The board chairman should not be an audit committee member, but may attend meetings by invitation.
- ▶ Audit committee members should collectively have an understanding of integrated reporting (including financial reporting), internal financial controls, the external and internal audit process, corporate law, risk management, sustainability issues, information technology governance and the governance processes within the company.
- ▶ The audit committee is responsible for the oversight of integrated reporting, internal audit and external audit and should determine annually whether the expertise, resources and experience of the finance function is appropriate.
- ▶ The audit committee should recommend to the board to engage an external assurance provider to provide assurance over material elements of the sustainability part of the integrated report. The audit committee should evaluate the independence and credentials of the external assurance provider.
- ▶ The audit committee should ensure that a combined assurance model is applied to provide a coordinated approach to all assurance activities.
- ▶ The audit committee must recommend to shareholders the appointment, reappointment and removal of external auditors. For listed companies, the audit committee should ensure that the external auditor that is recommended is approved by the JSE.
- ▶ The audit committee must develop a policy for board approval as to the nature, extent and terms under which the external auditor may perform non-audit services.
- ▶ Regardless of whether the audit committee has been assigned responsibility by the board for the oversight of risk management, it should satisfy itself that financial reporting risks, internal financial controls and fraud and IT risks as they relate to financial reporting have been appropriately addressed.
- ▶ The audit committee should evaluate the nature and extent of a formal documented review of internal financial controls to be performed by internal audit. The audit committee must conclude and report yearly to the board and stakeholders on the effectiveness of the company's internal financial controls.

## Key changes from King II

---

- ▶ The audit committee of a public company and state-owned company must be appointed by shareholders at the AGM.
- ▶ The audit committee should receive and deal appropriately with any complaints relating either to the accounting practices and internal audit of the company or to the content or auditing of its financial statements, or to any related matter.
- ▶ The audit committee should report in the integrated report:
  - ▶ The committee's role
  - ▶ Existence of formal terms of reference and if these have been adhered to



- ▶ Names and qualification of members and the period for which they have served
- ▶ The number of and attendance at meetings
- ▶ Whether it has considered and recommended the internal audit charter for approval by the board
- ▶ A description of the working relationship with the chief audit executive
- ▶ Information regarding any other responsibilities
- ▶ Whether it has complied with its legal, regulatory or other responsibilities
- ▶ Whether it has recommended the integrated report to the board for approval
- ▶ The audit committee should report at the AGM:
  - ▶ A description of how the functions were carried out
  - ▶ Satisfaction with the auditors independence
  - ▶ Any commentary considered appropriate in relation to the financial statements, accounting practices and internal financial control
- ▶ The board is required to develop a process for notifying the audit committee of reportable irregularities.
- ▶ The audit committee should annually evaluate the resources and expertise in the financial function. For listed companies the audit committee should evaluate the financial director.
- ▶ The audit committee should ensure that the

internal audit function is subject to an independent quality review, either in line with IIA standards or when the audit committee deems it appropriate.

- ▶ The audit committee should understand how the board and external auditor (and any other relevant external assurance provider) evaluate materiality for integrated reporting purposes.

## Rationale

Various changes and additions to the requirements were made to take the new Companies Act requirements into account and to strengthen the role and expectation of the audit committee.

The requirement for the listed company's audit committees to satisfy themselves as to the experience and competence of the finance director and for listed company's external auditors to be approved by the JSE were included in King III in order to align it with the JSE Listing Requirements.

The fact that the audit committee has been made responsible for overseeing integrated reporting and assurance of sustainability information is linked to the fact that sustainability per King III should be linked to the company's strategy and risks and has thus a more prominent role to play in the company.

# The governance of risk

## Key requirements

- ▶ The board is ultimately responsible for the governance of risk and is required to approve the risk management policy and plan.
  - ▶ Risk tolerance and risk appetite limits should be set and monitored by the board.
  - ▶ The execution of the risk strategy should be delegated to management and an experienced Chief Risk Officer (CRO) can assist with this. However ownership cannot reside in one person or function. Risk management has to be embedded into the day to day operations of the company.
  - ▶ The board should appoint a risk committee or it may be assigned to the audit committee. The risk committee should comprise a minimum three members (non-exec and exec) and the committees responsibilities should be defined in its terms of reference.
  - ▶ The board should disclose its views on the effectiveness of the company's risk management in the integrated report. Furthermore it should include undue, unexpected or unusual risks it has taken in the pursuit of reward as well as any material losses and the causes of the losses, with due regard to the company's commercially privileged information.
- origination and risk ownership ensuring proper due diligence and accountability.
  - ▶ Instinct: the ability to avoid 'following the herd' when there are systemic and pervasive risks.
  - ▶ Independence: the ability to view the company independently from its environment.
  - ▶ Interconnectivity: the ability to identify and understand how risks are related, especially when their relatedness might exacerbate the risk.
  - ▶ Each year, internal audit should provide a written assessment on the effectiveness of the company's system of internal control and risk management to the board. This provides the board with independent assurance on the integrity and robustness of the risk management process.

## Rationale

King III focuses on defining roles and responsibilities for risk management which is crucial in the successful embedding of risk management within organisations. Supporting this is the concept that risk must not reside with one person or function, ie, the CRO or the risk management function but requires an inclusive approach across the company in order to be successful.

The other key focus in this chapter is the adoption of an acceptable risk management approach/framework based on key principles rather than prescriptive measures.

In the last few years we have experienced significant corporate failures which in many instances could be said is due a company's failure to anticipate and react to risks. This includes risks that are systemic, as well as risks that are normally considered to be unpredictable; King III has identified this flaw in the approach to risk management and has recommended that companies consider these risks within a defined framework with specific characteristics.

## Key changes from King II

- ▶ An accepted and appropriate methodology should be adopted to identify, respond to and monitor risks. The risk assessment should include a framework to anticipate unpredictable risks, the framework should have the following characteristics:
  - ▶ Insight: the ability to identify the cause of the risk, where there are multiple causes or root causes that are not immediately obvious.
  - ▶ Information: comprehensive information about all aspects of risks and risk sources, especially of financial risks.
  - ▶ Incentives: the ability to separate risk



# The governance of information technology

## Key requirements

---

- ▶ Information Technology (IT) governance should be part of a company's governance structures and responsibility rests with the board.
- ▶ The board should ensure that the company's IT strategy is integrated with overall business strategy and processes. IT should be leveraged to improve the performance and sustainability of the company.
- ▶ The board should delegate to management the responsibility of implementing an IT governance framework. The CEO should appoint a person responsible for the management of IT, ie, Chief Information Officer (CIO). The CIO should be a suitable qualified and experienced person that has access to regularly interact on strategic IT matters.
- ▶ The board should monitor and evaluate significant IT investments and expenditure. This includes monitoring the value delivery of IT and the ROI of significant IT projects. In addition, independent assurance should be obtained on the IT governance practices of IT services outsourced to a third party.
- ▶ IT should form an integral part of the company's risk management practices and management should regularly demonstrate to the board that adequate business resilience arrangements are in place for disaster recovery. In addition, the board is responsible for ensuring that the company complies with relevant IT laws, rules, codes and standards.
- ▶ It is the board's responsibility to ensure that information assets are managed effectively. This includes information security, information management and information privacy.
- ▶ The risk and audit committee should assist the board in carrying out its IT responsibilities. The risk committee should ensure and obtain assurance that IT risks are adequately addressed.

The audit committee should consider IT risks as it relates to financial reporting and the going concern of the company. In addition, technology should be used to improve audit coverage and efficiency.

## Key changes from King II

---

- ▶ There is significantly more focus on IT. King II only addressed aspects relating to IT internal control, potential benefits from utilising technology to enhance reporting and transparency and the governance implications of e-business.
- ▶ King III addresses the key governance areas related to information technology and clearly places the responsibility of IT governance with the board.

## Rationale

---

As technology becomes increasingly important and integrated into business processes, the need for adequate governance and management of IT resources become imperative for any business. There are increased risks to organisations that embrace technology and therefore directors should ensure that reasonable steps have been taken by management to govern IT.

Companies are making significant investments in technology without being able to demonstrate the value delivered from such investments.

IT governance is an integral part of corporate governance and should not be seen in isolation. King III address IT governance in a separate chapter as it is a relatively new concept within corporate governance, however, companies should address IT governance within their existing corporate governance framework.

# Compliance with laws, codes, rules and standards

## Key requirements

- Compliance should be part of the risk management process, the culture of the company and the detailed policies and procedures.
- The structure, size, role and reporting line of the compliance function should be considered to ensure that it is appropriate for the company and should reflect the company's decision on how compliance is integrated with its ethics and risk management.
- Compliance is a board responsibility and should be a standing agenda item.
- The board should disclose in the integrated report how it has discharged its responsibility to ensure the establishment of an effective compliance framework and process.

## Key changes from King III:

- The board and each individual director has a duty to keep abreast of laws, regulations, rules and

standards applicable to the company as well as being accountable for the company's compliance with these.

## Rationale

Corporate compliance is taken to new level. Although corporate compliance was referred to in various sections of King II, King III dedicates a chapter specifically on compliance with laws, regulations, rules, codes and standards.

It is not just compliance to the minimum laws and regulations only, i.t.o. "keeping us out of trouble" that is prescribed, but consideration is given to adherence with "non-binding" rules, codes and standards to achieve good governance is envisaged.

Compliance is also not being "diluted" by marginalising it into the operations and / or that the company will be tempted to have operational issues take precedent over compliance issues.



# Internal audit

## Key requirements

- ▶ Companies should establish and maintain an effective internal audit function and if the board decides not to establish an internal audit function, full reasons should be provided in the company's integrated report.
- ▶ As part of its key responsibilities, internal audit is required to evaluate the company's governance processes including ethics, especially "tone at the top".
- ▶ Where outsourcing of the internal audit function is selected a senior executive or director should be responsible for the effective functioning of the internal audit activities.
- ▶ Internal audit should adopt a risk based approach and should be informed by and aligned to the strategy of the company.
- ▶ Internal audit, as a significant role player in the governance process, should contribute to the effort to achieve strategic objectives and should provide effective challenge to all aspects of the governance, risk management and internal control environment.
- ▶ An internal audit function should consider the risks that may prevent or slow down the realisation of strategic goals as well as the opportunities that will promote the realisation of strategic goals.
- ▶ The audit committee should ensure the internal audit function is subject to an independent quality assurance review in line with the IIA standards
- ▶ The Chief Audit Executive (CAE) should develop a sound working relationship with the audit committee by positioning internal audit as a trusted strategic adviser to the audit committee.

## Key changes from King II

- ▶ Internal audit should provide a written assessment of the effectiveness of the system of internal controls and risk management to the board. The assessment regarding internal financial controls should be reported specifically to the audit committee.
- ▶ Internal audit should play a pivotal role in the combined assurance model by providing independent assurance on risk management and internal controls.
- ▶ Internal audit should be strategically aligned to achieve its objectives and the CAE should have a standing invitation to executive and other strategically relevant meetings.

## Rationale

Internal audit executives are being continually pressured to improve their function's effectiveness and efficiency while increasing risk coverage and business improvement focus. Executive management and the audit committee continue to look to internal audit for balanced focus between compliance and business improvement.

In today's dynamic business world where risks change and emerge daily, internal audit needs to remain relevant and ensure they are flexible enough to align their work to the changing landscape. This supports the concept of internal audit being strategically aligned, furthermore the skills required within the internal audit need to keep up to these demands,

An independent quality assurance review is in line with the requirements of the International Internal Audit Standards for Professional Practice of Internal Auditing. Many audit committees and CAE's are requesting these independent reviews to:

- ▶ Provide the audit committee and executives with an independent assessment of the extent that internal audit function meets leading practices
- ▶ Determine the extent the work performed by the internal audit function complies with the "Standards" as prescribed by the Institute of Internal Auditors (IIA)
- ▶ Create an improvement agenda

With the shortage of skills and business focusing on their core activities, more and more internal audit functions are being outsourced. This is recognised but it is emphasised that the responsibility and accountability has to remain with the organisation.

The move to a combined assurance model is as a result of numerous risk providers such as risk management, legal and compliance, etc, within an organisation operating in silos with a lack of coordination. Internal audit is an integral part of the combined assurance model and as the board is required to report on the effectiveness of the systems of internal control they are now also looking for a written assessment from internal audit to guide them in this assessment. However, management and internal audit will need to define the components of the internal audit framework to which the internal control environment can be measured.





# Governing stakeholder relationships

## Key requirements

- ▶ Management should develop for adoption by the board a stakeholder management strategy and policy.
- ▶ Communication with stakeholders should be transparent, in simple language and understandable and in accordance with a responsible communication programme adopted by the board.
- ▶ A company should consider disclosing in its integrated report the number and reasons for refusals of requests for information lodged in terms of the Promotion of Access to Information Act, 2000.
- ▶ The board should ensure that internal and external disputes are resolved efficiently and effectively. Arbitration, mediation and conciliation are dispute resolution processes that the board can consider as alternatives to formal legal proceedings in court.

## Key changes from King II

- ▶ Alternate Dispute Resolution (ADR) is a new principle introduced in King III.

## Rationale

Stakeholder engagement is not a new concept for King, but because it forms the cornerstone of sustainability, which is one of the fundamental principles in King III, it has been expanded upon in a separate chapter in the report.

ADR has become accepted globally as an important element of good corporate governance. ADR allows disputes to be resolved efficiently, timeously and effectively taking both parties needs into account. This can contribute to preserving business relationship and allows for flexible solutions to be achieved.

# Integrated reporting and disclosure

## Key requirements

- ▶ Companies should report annually, through an integrated report, on the operations of the company, the sustainability issues affecting the business, the financial results, and the results of its operations and cash flows. The report should be complete, timely, relevant, accurate, honest and accessible and comparable with the company's past performance and should cover both positive and negative aspects of the company's impacts on stakeholders.
- ▶ The annual financial statements should be included in the integrated report.
- ▶ While a truly integrated report should be presented in one document, it can be presented in more than one document. However, if this is done, the documents should be made available at the same time and disclosed as an integrated report.
- ▶ Sustainability reporting should be independently assured.
- ▶ The scope of assurance should be agreed and disclosed.

- ▶ The International Standard on Assurance Engagements (ISAE3000) and AccountAbility's AA1000 Assurance Standard (AA1000AS) should be used in combination to provide assurance over sustainability information.

## Key changes from King II

- ▶ The previous King report focused on reporting whereas the recommendations now extend into the actual doing and inclusion into the business strategy.

## Rationale

In the words of Mervyn King in the preface to King III - "Sustainability is the primary moral and economic imperative for the 21st century."

Although sustainability reporting was recommended in King II, a renewed and extended focus was required and hence sustainability has been integrated in various sections throughout the King III report along with a separate chapter on integrated reporting.

# Our expertise

We have many professionals who can assist you implementing and interpreting the various requirements and recommendation of the King III Report.

Our key contacts are:

## **Mike Bourne, Director**

Professional Practice Group  
michael.bourne@za.ey.com  
+27 21 443 0258

## **Jayne Mammatt, Associate Director**

Climate Change & Sustainability Services  
jayne.mammatt@za.ey.com  
+27 11 772 3349

## **Celestine Munda, Director**

Business Risk Services - Internal Audit  
celestine.munda@za.ey.com  
+27 11 772 3315

## **Lisa Jonker, Director**

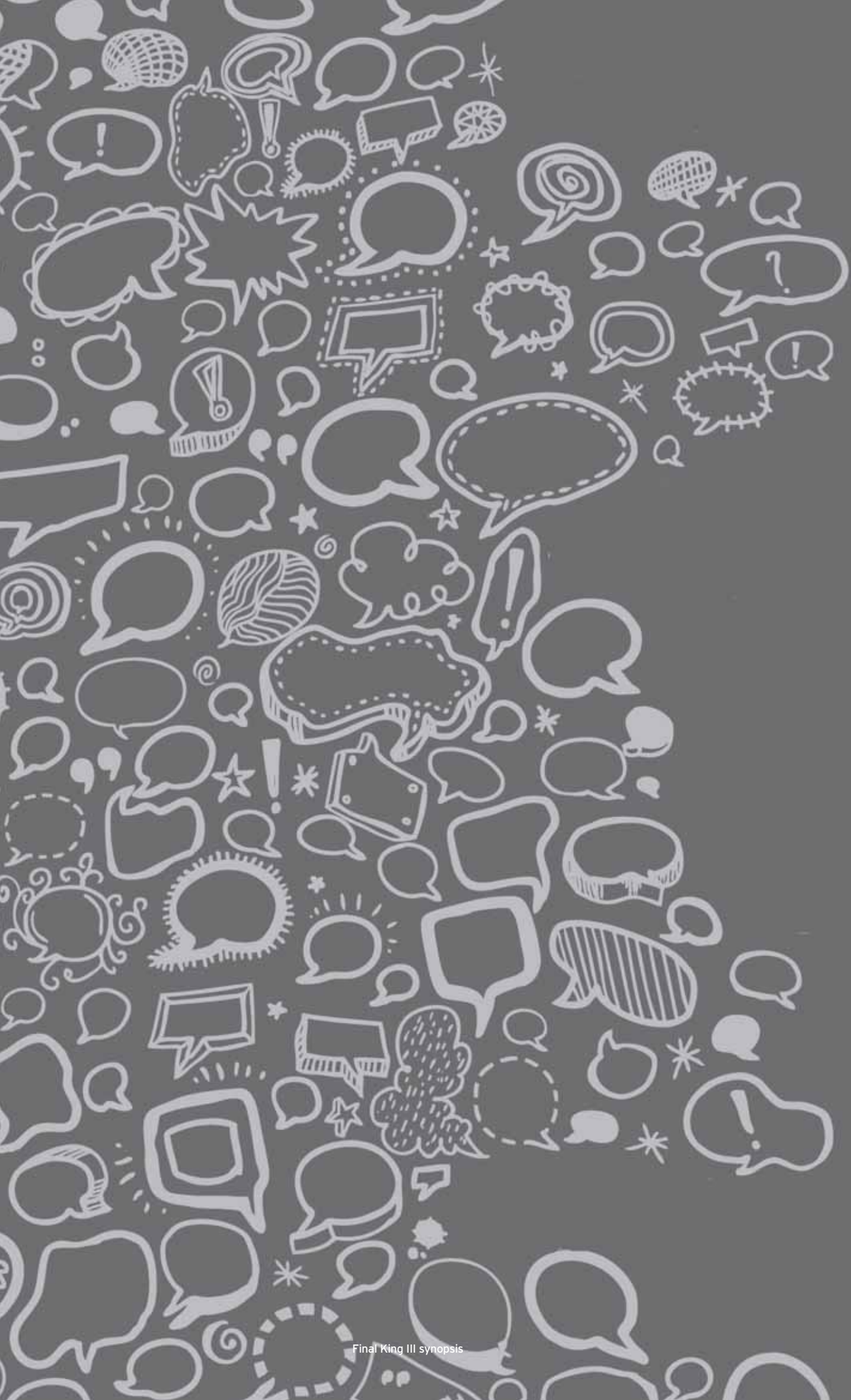
Business Risk Services - Enterprise Risk Management  
lisa.jonker@za.ey.com  
+ 27 83 454 0510

## **Marius Van der Berg, Director**

Information Technology Risk and Assurance  
marius.vandenberg@za.ey.com  
+ 27 11 772 3706







Ernst & Young

Assurance | Tax | Transactions | Advisory

#### About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 135,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

For more information, please visit  
[www.ey.com/za](http://www.ey.com/za)

Ernst & Young refers to the global organisation of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients.

© Ernst & Young South Africa 2009.  
All rights reserved.

Studio ref. 090901. Artwork by Govender.

