



Johannesburg 165 West Street, Sandton, Johannesburg PO Box 785812, Sandton 2146, South Africa Telephone +27 (0)11 669 9000 Fax +27 (0)11 669 9001

Cape Town SA Reserve Bank Building, 60 St George's Mall, Cape Town PO Box 248, Cape Town 8000, South Africa Telephone + 27 (0)21 480 7800 Fax +27 (0)21 424 1688

London 7 John Street, London, WC1N2ES Telephone +44 (0)207 084 7460 Fax +44 (0)207 831 3134 **Web** www.bowman.co.za

IN ASSOCIATION WITH COULSON HARNEY

Nairobi Unit A, Nairobi Business Park, Ngong Road, Nairobi PO Box 10643-00100, Nairobi, Kenya

Telephone +254 (0)20 386 1686 Fax +254 (0)20 386 1687 **Web** www.coulsonharney.com



Table of contents

1. Introduction	1	8. The governance elements	3
2. What is 'King III'?	1	8.1 Ethical leadership and corporate citizenship	3
3. Effective date	1	8.2 Boards and directors	3
4. 'Apply or explain'	1	8.3 Audit committees	5
5. The link between governance principles and law	1	8.4 The governance of risk	7
6. Application of the code	2	8.5 The governance of Information Technology	8
7. Key aspects of King III	2	8.6 Compliance with laws, rules, codes and standards	8
		8.7 Internal audit	8
		8.8 Governing stakeholder relationships	8
		8.9 Integrated reporting and disclosure	9
		9. Conclusion	9

1. Introduction

The third report on corporate governance in South Africa, authored by the King Committee, has been published as the King Report on Governance for South Africa 2009 and the King Code of Governance Principles, commonly referred to as King III. King III replaces the previous King Reports (King I and King II) and intends to place South Africa at the forefront of governance internationally. The introduction to King III states that a new report on corporate governance became necessary because of the new Companies Act, 2008, and also because of changes in international governance trends.

The object of corporate governance rules is to improve the quality of leadership which boards are giving to their businesses. Corporate governance guidelines seek to assist directors to understand what good governance requires of them. As discussed in more detail below, King III adopts an 'apply or explain' approach to corporate governance. This is different from the 'comply or explain' approach adopted by King II, but King III continues to follow a voluntary basis for governance compliance.

As Mervyn King points out in his book *The Corporate Citizen*, good governance requires intellectual honesty and is not simply the mindless compliance with the guidelines in a code or the provisions of a statute. It is worth quoting from Mervyn King's book:

"Good governance will not result from a mindless quantitative compliance with a governance code or rules.

Good governance involves fairness, accountability, responsibility and transparency on a foundation of intellectual honesty. One has to employ one's practised abilities and honestly apply one's mind in an unfettered and unbiased manner in making a decision that is in the best interests of the company."

This guide highlights some of the noteworthy issues arising from King III.

2. What is 'King III'?

What is referred to as 'King III' really comprises the King Report on Governance for South Africa 2009 ("the Report"), the King Code of Governance Principles for South Africa 2009 ("the Code") and Practice Notes to King III issued by the Institute of Directors which provide guidance in regard to the implementation of the Code.

The Code deals with a number of governance elements, each of which is broken down into different principles which must be applied. In applying these principles there are best practice recommendations in the Code, which are amplified in the Report.

3. Effective date

King III is effective from 1 March 2010.

4. 'Apply or explain'

As with King I and King II, King III follows a voluntary basis for governance compliance. In other words there is a code of principles and practices on a non-legislated basis.

King III adopts an 'apply or explain' approach which means that the board of directors, in its collective decision making, could conclude that to follow a recommendation would not, in the particular circumstances, be in the best interests of the company. The board could decide to apply the recommendation differently or apply another practice and still achieve the objective of overarching corporate governance principles of fairness, accountability, responsibility and transparency.

The current approach has evolved from the 'comply or explain' approach adopted in King II. The reason for the change is simply that the King Committee believes that the language more appropriately conveys the intent of the King Code from inception rather than comply or explain. The comply or explain approach could denote a mindless response to the Code and its recommendations, whereas the 'apply or explain' regime shows an appreciation for 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. To quote from the introduction to King III: *"In reality, the ultimate compliance officer is not the company's compliance officer or a bureaucrat ensuring compliance with statutory provisions, but the stakeholders."*

5. The link between governance principles and law

The next important point in the governance compliance framework is that 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 unhook governance from the law.

The starting point of an analysis on this topic is the duty of directors and officers to discharge their legal duties. These duties are grouped into two categories, namely: the duty of care, skill and diligence, and the fiduciary duties. As far as the body of legislation that applies to a company is concerned, corporate governance mainly involves the establishment of structures and processes, with appropriate checks and balances that enable the directors to discharge their legal responsibilities, and oversee compliance with legislation.

In addition to compliance with legislation, the criteria of good governance, governance codes and guidelines will be relevant to determine what is regarded as an appropriate standard of conduct for directors. The more established certain governance practices become, the more likely a court would regard conduct that conforms with these practices as meeting the required standard of care. Corporate governance practices, codes and guidelines therefore lift the bar of what are regarded as appropriate standards of conduct. Consequently, any failure to meet a recognised standard of governance, albeit not legislated, may render a board or individual director liable at law.

6. Application of the code

In contrast to King I and King II, King III applies to all entities regardless of the manner and form of incorporation or establishment and whether in the public, private sectors or non-profit sectors. King III provides that all entities should apply

the principles and the Code and consider the best practice recommendations and the Report.

All entities should by way of explanation make a positive statement about how the principles have been applied or have not been applied. This level of disclosure will allow stakeholders to comment on and challenge the board on the quality of its governance.

The manner of application will differ for each entity and is likely to change as the aspirational nature of the Code should drive entities to continually improve governance practices. It is important to understand that the 'apply or explain' approach requires more consideration and explanation of what has actually been done to implement the principles and best practice recommendations of governance. The introduction to the Code and Report specifically state that:

"Each principle is of equal importance and together forms a holistic approach to governance. Consequently, 'substantial' application of this Code and the Report does not achieve compliance."

7. Key aspects of King III

The philosophy of King III revolves around leadership, sustainability and corporate citizenship.

Leadership: Good governance is essentially about effective leadership. Leadership is characterised by the ethical values of responsibility, accountability, fairness and transparency. Responsible leaders direct company strategies and operations with a view

to achieving sustainable economic, social and environmental performance.

Sustainability: It should be understood that business, society and nature are interconnected in complex ways and the sustainability of the company in this environment should be the primary moral and economic imperative.

Corporate citizenship: Companies as "persons" should operate in a sustainable manner. Sustainability considerations are rooted in the South African Constitution, which is the basic social contract that South Africans have entered into.

Another key aspect of King III relates to the importance of *integrated reporting*. The need for integrated reporting stems from the fact that normal financial reporting of companies generally provide a picture of its financial position at a particular point in time, but that there is a need to provide forward-looking information to provide stakeholders with assurances on the prospects of the company looking into the future. Therefore King III recommends integrated sustainability performance and integrated reporting to enable stakeholders to make a more informed assessment of the economic value of the company. The integrated report should have sufficient information to record how the company has both positively and negatively impacted on the economic life of the community in which it operated during the year under review, often categorised as environmental, social and governance issues.

8. The governance elements

What follows below is a brief overview of the governance elements and governance principles set out in the Code, with some references to the Report.

8.1 Ethical leadership and corporate citizenship

8.1.1 The first principle dealt with in King III under ethical leadership and corporate citizenship is that *the board should provide effective leadership based on an ethical foundation*. Good corporate governance is essentially about effective, responsible leadership. Responsible leadership is categorized by ethical values of responsibility, accountability, fairness and transparency. To provide this the leadership of companies should direct the strategy and operations to build a sustainable business, while doing business ethically and considering the short and long-term impacts of the strategy on the economy, society and the environment and taking into account the company's impact on internal and external stakeholders.

8.1.2 The second principle is that *the board should ensure that the company is and is seen to be a responsible corporate citizen*. The board should consider not only the financial performance but the impact of the company's operations on society and the environment. This includes being guided by

the Constitution and the Bill of Rights and to ensure that measurable corporate citizenship programmes are implemented.

Corporate citizenship and sustainability require business decision makers to adopt a holistic approach to economic, social and environmental issues in their core business strategy. Increasingly, companies view corporate, social and environmental responsibility, corporate, social investment and other social initiatives as central to doing business. Companies no longer treat these initiatives as merely ad hoc or nice to have, but as an integral part of their business strategy. This in turn supports business growth.

8.1.3 *The board should ensure that the company's ethics are managed effectively*. Good corporate governance requires that the board takes responsibility for building and sustaining an ethical corporate culture in the company. Such a culture consists of both formal and informal cultural systems. Selection and reward systems, for example, are elements of formal culture whereas "living" practices and language usage are elements of informal culture. A cultural approach to governing and managing the company's ethics would ensure that ethical standards infuse both formal and informal cultural elements.

A code of conduct and ethics related policies must be implemented and its implementation measured and adherence rewarded. The company's ethics performance should also be reported and disclosed.

8.2 Boards and directors

8.2.1 The first principle in regard to boards and directors is that *the board should act as the focal point for and custodian of corporate governance*. This entails the board having a board charter setting out its responsibilities, that the board should meet at least four times per year and monitor the relationship between management and the other stakeholders of the company to ensure that the company survives and thrives.

8.2.2 The next principle is that *the board should appreciate that strategy, risk, performance and sustainability are inseparable*. This means that the board should ensure that the strategy is aligned with the purpose of the company, the value drivers of its business and the legitimate interests and expectations of stakeholders. All risk should be thoroughly examined by management so as to remove those risks.

8.2.3 The next principle is closely linked to the governance elements of ethical leadership and corporate citizenship, namely that *the board should provide effective leadership*

based on an ethical foundation. Linked to this are the principles that *the board should ensure that the company is, and is seen to be a responsible corporate citizen and that the board should ensure that the company's ethics are managed effectively.*

8.2.4 *The board and its directors should act in the best interests of the company.* This means that the directors must adhere to the legal standards of conduct but also that real or perceived conflicts of interest should be disclosed to the board and managed.

8.2.5 *The board should consider business rescue proceedings or other turnaround mechanisms as soon as the company is financially distressed as defined in the New Companies Act.* This really means that the board must monitor the solvency and liquidity of the company continuously and that action is taken early to ensure that the company does not become a financially distressed company. If, despite the action taken by the board, the company remains in financial distress, action must be taken by the board to stop trading and place it in liquidation.

8.2.6 *The board should elect a chairman of the board who is an independent non-executive director. The CEO of the company should not also fulfil the role of chairman of the board.* The chairman of the board should be elected on an annual basis and should be

independent and free of conflict upon appointment. The chairman's ability to add value and his performance against what is expected of his role and function should be assessed every year. The board should ensure a succession plan for the role of the chairman.

8.2.7 *The board should appoint a chief executive officer and establish a framework for the delegation of authority.* The board should appoint the CEO and define its own level of materiality and approve a delegation of authority framework. The board should also ensure that the role and function of the CEO is formalized and the performance of the CEO is evaluated against the criteria specified by the board. Proper succession planning for the CEO and other senior executives must be put in place by the board.

8.2.8 *The board should comprise a balance of power with a majority of non-executive directors. The majority of non-executive directors should be independent.* When determining the number of directors serving on the board the knowledge, skills and resources required for conducting the business of the board should be considered. Every board should consider whether its size, diversity and demographics make it effective.

Every board should have a minimum of two executive directors of which one should be the CEO and the other the director responsible for finance.

At least one third of the non-executive directors should rotate every year.

Any independent non-executive director serving more than nine years should be subjected to a rigorous review of independence and performance by the board.

The board should be permitted to remove any director without shareholder approval.

8.2.9 *The directors should be appointed through a formal process.* The nomination committee should assist with the process of identifying suitable members of the board and the appointment of non-executive directors should be formalised through a letter of appointment.

8.2.10 *The induction of and ongoing training and development of directors should be conducted through formal processes.* The board must ensure that formal induction programmes are established for new directors and that inexperienced directors are developed through mentorship programmes. There should also be continuing professional development programmes and directors must receive regular briefings on changes and risks, laws and the environment.

8.2.11 *The board should be assisted by a competent, suitably qualified and experienced company secretary.* The board should appoint and remove the company secretary and should empower the company

secretary to enable the person to properly fulfil his duties. The company secretary should have an arm's length relationship with the board and should not be a director of the company.

The company secretary should assist the nominations committee with the appointment of directors and assist with director induction and training programmes. The company secretary should provide guidance to the board on the duties of directors and good governance. The company secretary should ensure board and committee charters are kept up to date. The company secretary should assist with the evaluation of the board committees and individual directors.

8.2.12 *The evaluation of the board, its committees and the individual directors should be performed every year.* These yearly evaluations should be performed by the chairman or an independent person. The results of performance evaluations should identify training needs of directors. The nomination for the re-appointment of directors should only occur after the evaluation of the performance and attendance at meetings of the director.

8.2.13 *The board should delegate certain functions to well-structured committees but without abdicating its own responsibilities.* Formal terms of reference should be established and approved for each committee of the board.

These terms of reference should be reviewed yearly. Committees, other than the risk committee, should comprise a majority of non-executive directors of which the majority should be independent.

8.2.14 *A governance framework should be agreed between the group and its subsidiary boards.* Holding companies must respect the fiduciary duties of directors serving in a representative capacity on the board of the subsidiary. The implementation and adoption of policies, processes and procedures of holding companies should be considered and approved by the subsidiary company's board, if it considers them appropriate.

8.2.15 *Companies should remunerate directors and executives fairly and responsibly.* Companies should adopt remuneration policies aligned with the strategy of the company and linked to individual performance. These policies should create value over the long term.

8.2.16 *Companies should disclose the remuneration of each individual director and certain senior executives.* The remuneration report included in the integrated report should include:

- all benefits paid to directors
- the salaries of the three most highly paid employees who are not directors
- the policy on base pay
- participation and share incentive schemes
- the use of bench marks

- incentive schemes to encourage retention
- justification of salaries above the median
- material payments that are ex-gratia in nature
- policies regarding executive employment
- the maximum expected potential dilution as a result of incentive awards.

8.2.17 *Shareholders should approve the company's remuneration policy.* Shareholders should pass a non-binding advisory vote on the company's yearly remuneration policy and the board should determine the remuneration of executive directors in accordance with the remuneration policy put to shareholders vote.

8.3 Audit committees

The next governance element in King III deals with audit committees. An independent audit committee fulfils a vital role in corporate governance. The committee is vital to, amongst other things, ensure the integrity of integrated reporting and internal financial controls and ensure that they identify and manage financial risks.

8.3.1 The first principle discussed by King III under audit committees is that *the board should ensure that the company has an effective and independent audit committee.* Once established the audit committee's composition, purpose and duties must be established and the board should approve the terms of reference of the

audit committee. The audit committee should meet as often as is necessary to fulfil its functions but at least twice a year. The audit committee should meet with the internal and external auditors at least once a year without management being present.

8.3.2 The second principle is that the audit committee members should be suitably skilled and experienced independent non-executive directors. The audit committee should consist of at least three members. The chairman of the board should not be the chairman or member of the audit committee. Any vacancies on the audit committee should be filled by the board.

8.3.3 The next principle is that the audit committee should be chaired by an independent non-executive director elected by the board. The chairman of the audit committee should participate in setting and agreeing the agenda of the committee. The chairman of the audit committee should be present at every AGM of the company.

8.3.4 The audit committee should oversee integrated reporting. The audit committee should have regard to all factors and risks that may impact on the integrity of the integrated report. The audit committee should review and comment on the financial statements included in the integrated report. The audit committee should review the disclosure of sustainability issues in the integrated report to ensure that it is reliable and does not conflict with the financial statements.

8.3.5 The audit committee should ensure that a combined assurance model is applied to provide a coordinated approach to all assurance activities. Combined assurance refers to assurance processes in a company aimed at maximising risk and governance oversight and control efficiencies, and optimise overall assurance to the audit and risk committees, considering the company's risk appetite. The audit committee must ensure that the combined assurances received are appropriate to address all significant risks facing the company.

8.3.6 The audit committee should satisfy itself of the expertise, resources and experience of the company's finance function. This entails a yearly review of the finance function. The results of such review should be disclosed in the integrated report.

8.3.7 The audit committee should be responsible for overseeing the internal audit and the audit committee should approve the internal audit plan. The audit committee should also ensure that the internal audit function is subject to an independent quality review as and when the audit committee determines it is appropriate.

8.3.8 The audit committee should be an integral component of the risk management process. The audit committee should specifically have oversight of:

- financial reporting risks
- internal financial controls
- fraud risks as it relates to financial reporting
- IT risks as it relates to financial reporting

8.3.9 The audit committee is responsible for recommending the appointment of the external auditor and overseeing the external audit process. The audit committee must nominate the external auditor for appointment and must approve the terms of engagement and remuneration for the external auditor. The audit committee is responsible for monitoring and reporting on the independence of the external auditor and must define a policy for non-audit services provided by the external auditor and must approve the contracts for non-audit services. The audit committee is also responsible for the review of the quality and effectiveness of the external audit process and should be informed of any reportable irregularities identified and reported by the external auditor.

8.3.10 The audit committee should report to the board and shareholders on how it has discharged its duties.

8.4 The governance of risk

The governance of risk is the next governance element which entails that the board must exercise leadership to prevent risk management from becoming a series of activities that are detached from the realities of the company's business.

8.4.1 The board should be responsible for the governance of risk and must have a policy and plan for a system and process of risk management. The board should comment in the integrated report on the effectiveness of the system and process of risk management. The board's responsibility for risk governance should also be expressed in the board charter. The induction and ongoing training programmes for the board should incorporate risk governance. The board should also have a documented risk management policy and plan which must be approved by the board and distributed through the company. The board must review the implementation of the risk management plan at least once a year, although its implementation should be monitored continually.

8.4.2 The board should determine the levels of risk tolerance and the board must set levels of risk tolerance once a year. It may also set limits for the risk appetite, but the board should monitor the risks taken to ensure that they are

within the tolerance and appetite levels.

8.4.3 The risk committee or audit committee should assist the board in carrying out its risk responsibilities. The board should appoint a committee responsible for risk and such committee should:

- consider the risk management policy and plan and monitor the risk management process
- have as its members executive and non-executive directors, members of senior management and independent risk management experts to be invited, if necessary
- have a minimum of three members
- convene at least twice per year.

8.4.4 The board should delegate to management the responsibility to design, implement and monitor the risk management plan. Management of a company is responsible for the execution of the board's risk strategy and is responsible for integrating risk management in the day-to-day activities of the company. For this purpose the chief risk officer should be a suitably experienced person who should have access and interact regularly on strategic matters with the board or appropriate board committees and executive management.

8.4.5 The board should ensure that the risk assessments are performed on a continual basis

by a systematic, documented formal risk assessment which should prioritise and rank risks to focus responses and interventions.

8.4.6 The board should ensure that the frameworks and methodologies are implemented to increase the probability of anticipating unpredictable risks and the board should ensure that a framework and processes are in place to anticipate unpredictable risks.

8.4.7 The board should ensure that management considers and implements appropriate risk responses and management should identify and note in the risk register the risk responses decided upon. Management should demonstrate to the board that the risk responses provided for the identification and exploitation of opportunities to improve the performance of the company.

8.4.8 The board should ensure continual risk monitoring by management and their responsibility for monitoring should be defined in the risk management plan.

8.4.9 The board should receive assurance regarding the effectiveness of the risk management process.

8.4.10 The board should ensure that there are processes in place enabling complete, timely, relevant, accurate and accessible risk disclosure to stakeholders.

8.5 The governance of Information Technology

8.5.1 *The board should be responsible for Information Technology (IT) governance. IT is an integral part of any business and is fundamental to support, sustain and grow the business. It is crucial for the board to understand the importance of IT and assume responsibility for governance of IT. This entails the establishment and implementation of an IT governance charter and policies. The board must be assured of the effectiveness of IT governance. What follows are the further principles in King III which are self explanatory.*

8.5.2 *IT should be aligned with the performance and sustainability objectives of the company.*

8.5.3 *The board should delegate to management the responsibility for the implementation of an IT governance framework.*

8.5.4 *The board should monitor and evaluate significant IT investments and expenditure.*

8.5.5 *IT should form an integral part of the company's risk management.*

8.5.6 *The board should ensure that information assets are managed effectively.*

8.5.7 *A risk committee and audit committee should assist the board in carrying out its IT responsibilities.*

8.6 Compliance with laws, rules, codes and standards

8.6.1 *The board should ensure that the company complies with applicable laws and considers adherence to non-binding rules, codes and standards. Obviously, companies must comply with all applicable laws. Even if it is not law, companies must consider adherence to non-binding rules, codes and standards. Compliance with laws should not be a mindless compliance with rules, but should be considered as an expression of ethical rules and standards. Compliance also entails benefiting from the rights afforded by the law. It also entails an understanding of the laws in a broader context, to achieve this the following principles are important.*

8.6.2 *The board and each individual director should have a working understanding of the effect of the applicable laws, rules, codes and standards on the company and its business.*

8.6.3 *Compliance risk should perform an integral part of the company's risk management process.*

8.6.4 *The board should delegate to management the implementation of an effective compliance framework and processes.*

8.7 Internal audit

8.7.1 *The board should ensure that there is an effective risk based internal audit.*

8.7.2 *Internal audit should follow a risk based approach to its plan.*

8.7.3 *Internal audits should provide a written assessment of the effectiveness of the company's system of internal controls and risk management.*

8.7.4 *The audit committee should be responsible for overseeing internal audit.*

8.7.5 *Internal audit should be strategically positioned to achieve its objectives.*

8.8 Governing stakeholder relationships

8.8.1 *The board should appreciate that stakeholders' perceptions affect a company's reputation.*

8.8.2 *The board should delegate to management to proactively deal with stakeholder relationships.*

8.8.3 *The board should strive to achieve the appropriate balance between its various stakeholder groupings, in the best interest of a company.*

8.8.4 *Companies should ensure the equitable treatment of shareholders.*

8.8.5 *Transparent and effective communication of stakeholders is essential for building and maintaining their trust and confidence.*

8.8.6 *The board should ensure that disputes are resolved as effectively, efficiently and expeditiously as possible.*

8.9 Integrated reporting and disclosure

Integrated reporting is the holistic and integrated representation of the company's performance in terms of both its finance and its sustainability.

8.9.1 *The board should ensure that the integrity of the company's integrated report.*

The company should have controls to enable it to verify and safeguard the integrity of its integrated report. The board should delegate to the audit committee to evaluate sustainable disclosures and the integrated report should:

- be prepared every year
- convey adequate information regarding the company's financial sustainability performance
- focus on substance over form.

8.9.2 *Sustainability reporting and disclosure should be integrated with the company's financial reporting and the board should include commentary on the*

company's financial results. The board must disclose that the company is a going concern and the integrated report should describe how the company has made its money. The integrated report must convey the positive and negative impacts of the company's operations and plans to improve the positives and eradicate or ameliorate the negatives in the financial year ahead.

8.9.3 *Sustainability reporting and disclosure should be independently assured, mainly by delegating to the audit committee general oversight and reporting of sustainability.*

9. Conclusion

Companies do not operate in a vacuum and the environment within which they operate should inform how they conduct business. If governance of companies takes this into account in a responsible, honest and ethical manner it will assist companies' sustainability, and ensure that directors discharge their duties to stakeholders.

Copyright: The Institute of Directors in South Africa owns the copyright in King III and has given its written permission for the use of the information contained in King III in this guide.

This guide was prepared by Rudolph du Plessis, a partner in the corporate department of Bowman Gilfillan.

This guide is not intended to be legal advice, and is merely a quick reference guide to King III. Where specific advice is needed, specific legal advice should be sought on each individual point.