

Corporate Governance and King III



The third South African report on corporate governance (King III) was released on 1 September 2009 and became effective on 1 March 2010.

King III summary

In this King III summary document, we have provided an overview as well as a quick reference guide but the reader is advised to consult the full King III Report and Code available from the Institute of Directors in South Africa.

Applicability

King III applies to "all entities regardless of the manner and form of incorporation or establishment of whether in the public, private or non-profit sectors."

'Apply or explain' versus 'Comply or explain'

King III has opted for the more flexible 'apply or explain' approach to its principles and recommended practices. In the United Kingdom, the UK Governance Code, which is based on the 'comply or explain' principle, requires London listed companies to state their compliance with the principles and then explain if there is non-compliance to any of the detailed provisions supporting the principle. In South Africa, under King III, entities are required to make a statement as to whether or not they apply the principles and then to explain their practices. It is relevant too that King III states "Each principle is of equal importance, consequently 'substantial' application of this Code and Report does not achieve compliance."

It is also noteworthy that the JSE subsequently put out minimum disclosure requirements for listed companies in November 2013.

Sustainability

There is increased emphasis on sustainability and its inseparable interface with strategy and control. King III calls for integrated reporting (reporting of financial information with sustainability issues of social, economic and environmental impacts) and recommends that the audit committee engage an external assurance provider to provide assurance over material aspects of the sustainability reporting in the integrated report.

Stakeholder inclusive model

King III follows an inclusive approach to stakeholders, whereby the legitimate interests of stakeholders (eg employees, suppliers, customers, regulators, the environment, community, etc) are considered and recognised over and above solely the shareholders' interests, in a manner which befits the long term sustainability of the entity.



Board composition

King III requires boards to be comprised of a majority of non-executive directors, of whom the majority should be independent. Every year the directors who are classified as independent should have their independence assessed by the board, particularly those that have been on the board for longer than nine years. The results should be reported.

Audit committee composition and duties

King III requires an independent and suitably skilled audit committee to be appointed by the shareholders. This committee also has statutory duties in terms of the Companies Act 71 of 2008, which are apart from the board of directors. The duties of the audit committee are extensive and include overseeing integrated reporting, external audit, internal audit, the risk management process and ensuring that the finance function is effective. Part of the Audit committee function in relation to risk management, is to oversee the IT risks and fraud risks as it relates to financial reporting and the internal financial controls. The Audit committee must report to the board on its effectiveness. The board in turn, has to report on the effectiveness of the system of internal controls.

Internal Audit

King III requires companies to establish an internal audit function which provides assurance over the company's governance, risk management and internal controls. Internal audit will be required to provide a written assessment of the system of internal controls and risk management to the board, as well as a written assessment of the internal financial controls to the audit committee.

(King III differs from Sarbanes-Oxley in that no attestation is required from external auditors on internal controls on financial reporting).

Risk management

Under King III, risk management remains important and more detailed guidance is given on how it is to be accomplished. The board is responsible for the governance of risk and disclosure. Management is responsible for the risk management design, implementation and monitoring of the risk management plan.

IT governance

King III highlights the role of IT governance and the board's related responsibilities. The recommendations are extensive.

Compliance

King III states that compliance should form an integral part of the risk management function and that companies should consider establishing a compliance function.

Remuneration, disclosure and shareholders' – votes

King III requires disclosure of the remuneration of each individual director and senior executives. Guidance is given on remuneration policy and practices, including that non-executive directors should not receive share options. King III recommends that the remuneration policy be put to the shareholders for a non-binding advisory vote and that the board should determine the remuneration of the executive directors in line with the policy.

Alternate Dispute Resolution (ADR)

King III advocates that an enforceable ADR clause should be inserted in contracts, so as to efficiently resolve disputes according to the needs of parties, rather than just their legal rights and obligations.

Director development and performance management

King III recommends induction for directors newly appointed to the board and its committees. In addition, ongoing training and professional development is recommended for directors. Annual performance assessments of the board, its committees and the individual directors are also recommended.



King III - Quick Reference Guide

The quick King III reference guide that follows contains a summary and extracts of the salient details. However, the reader is encouraged to consult the full King III Report and the Code of Governance Principles, now available from the Institute of Directors in Southern Africa.

Board and Directors

The board, director and company refers to the functional responsibility of those charged with governance in any entity.

Role of the board

The board should:

- Lead the entity ethically for sustainability in terms of the economy, environment and society, taking into account its impact on internal and external stakeholders
- Strategically direct, control, set the values, align management to the latter and promote a stakeholder inclusive approach of governance
- Ensure that each director adheres to the duties of a director
- Ensure that the company is and is seen to be a responsible corporate citizen
- Ensure the company's ethics are managed effectively through building an ethical culture, setting ethics standards, measuring adherence and incorporating ethics into its risk management, operations, performance management and disclosure
- Be the focal point of governance, have a charter, meet at least four times a year, monitor management and stakeholder relations and ensure the company survives and thrives
- Appreciate that strategy, risk, performance and sustainability are inseparable
- Ensure the company has an effective and independent audit committee

- Govern risks
- Be responsible for IT governance
- Ensure the company complies with laws and considers rules, codes and standards
- Ensure there is an effective risk – based internal audit function
- Ensure integrity of the integrated report
- Report on the effectiveness of internal controls
- Act in the best interests of the company (including managing conflicts and dealing in securities)
- Immediately consider business rescue proceedings should the company become financially distressed
- Elect annually an independent, non-executive director as chairman. If the chairman is not independent or is executive, then a lead independent non-executive director should be appointed and justified in the integrated report. The CEO may become chairman after three years. The number of chairmanships should be considered and there should be a chairman succession plan
- Appoint the CEO, define the board's materiality, establish a delegation of authority, evaluate CEO performance and ensure a succession plan for the CEO and senior executives.

Structure and composition of the board

The board should comprise a balance of power with:

- A majority of non-executive directors, of whom the majority should be independent
- Knowledge, skills, resources, size, diversity and demographics of board to be considered
- A minimum of two executive directors (CEO and Finance Director)
- The CEO and chairman positions should be separate
- One third of non-executives should rotate annually
- Non-executive directors on the board for longer than nine years must be assessed annually for independence and this should be reported

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

The King Report provides detailed guidance on the role of the chairman and the CEO.

Appointment, development and performance assessment of directors

- A formal process should be established for appointment and development of directors
- A nominations committee should assist with the identification and recommendation of potential directors to the board
- Backgrounds and references should be checked before nomination
- Letters of appointment should be provided to non-executive directors
- Full disclosure of directors should be made to shareholders (King III has details of disclosure eg education, experience, age, other directorships, etc)
- Directors should receive induction and ongoing training (including changes to laws, rules, standards and codes)
- The performance of the board, its committees and individual directors should be evaluated every year by the chairman or an independent provider. Results should assist training and be disclosed in the integrated report
- Performance evaluation results should inform the nomination for the re-appointment of a director.

Company secretary

- The board should appoint/remove, empower and be assisted by a competent, qualified and experienced company secretary (who is not a director and who is at 'arms-length')
- The company secretary should assist the nominations committee, facilitate training, provide guidance to the board, keep the board and committee charters current, prepare and circulate board papers, assist communication into and around board meetings, assist in drafting workplans, keep minutes and assist with evaluations of the board, committees and individual directors.

King III - Quick Reference Guide

Group boards of companies

A governance framework should be agreed between the group and its subsidiary boards (subject to legal and fiduciary duties of subsidiary directors to the subsidiary company). Implementation and adoption of policies, processes or procedures of the holding company should be considered and approved by the subsidiary company and disclosed by the subsidiary company. Where the holding company of a South African subsidiary is listed on another exchange, King III principles should be applied to the subsidiary.

Committees

Audit, risk, nomination and remuneration committees should be established.

The Companies Act also requires a social and ethics committee and King III principles would also apply.

Board committees should have:

- Terms of reference approved by the board that are reviewed annually
- Composition and terms of reference should be disclosed in the integrated report
- Composition should comprise a majority of non-executive directors of which the majority should be independent (risk committee may have a mixed composition – refer below and the social and ethics committee requires a minimum of three directors, one of whom must be independent - refer to Companies Act, 2008)
- The chairman should not be a member of the audit committee (but refer to JSE Guidance on exceptions). He/she should not chair the risk or remuneration committees but may be a member of these committees
- The chairman should be a member of the nomination committee and may also be its chairman
- The CEO should not be a member of the remuneration, audit or nomination

committees but should attend by invitation. CEO's should recuse themselves when conflicts arise or when their performance and/or remuneration is discussed. The CEO should not become a chairman of a company outside the group

- External advisors and executive directors may attend by invitation. Non-directors serving as members on committees of the board should be aware of sections 76 and 77 of the Companies Act 71 of 2008 which places the same standards of conduct and liability as if they were directors (but without the benefit of a committee vote)
- Committees should be able to take outside professional advice subject to following an approved process
- Committee chairmen should give at least an oral summary of their committee's deliberations at the following board meeting.

Remuneration committees and remuneration

- Companies should remunerate directors and executives fairly and responsibly ie: align remuneration policies to company strategy and individual performance. Detailed guidance is provided in the report as to what is considered fair and responsible remuneration practices
- The remuneration committee should assist the board with setting and administering remuneration policies (which should address base pay, bonuses, contracts, severance, retirement benefits, share and incentive schemes)
- Non-executive director fees should comprise a base and an attendance fee component. Non-executive directors and the chairman should not receive share options or other incentive awards. Non-executive director fees should be approved by shareholders in advance by way of special resolution at intervals of not more than two years
- The detail of each individual directors' remuneration as well as that of the senior executives should be disclosed within the remuneration report in the integrated report. Other information to be disclosed should be base pay

policy, participation in incentive schemes, benchmarks used, retention schemes, justifications for salaries above medians, material ex-gratia payments, executive employment policies and maximum potential dilution from incentive awards

- Shareholders should vote a non-binding advisory vote on the company's remuneration policy (including share schemes)
- The board should determine executive directors' remuneration in accordance with the policy put to shareholders.

Audit committees

The board should ensure that it has an effective and independent audit committee, with approved terms of reference. The audit committee is an integral part of the risk management process with oversight of financial reporting risks, internal financial controls and fraud and IT risks relevant to financial reporting.

The audit committee should:

- Consist of at least three independent members, all of whom should be independent non-executive directors. The chairman of the board should not be the chairman of, nor a member of, the audit committee (but refer to JSE Guidance on exceptions) The audit committee chairman should be elected by the board, set the agenda and be present at the audit committee meeting
- Meet at least twice a year (at least once a year external and internal auditors should attend without management)
- Have sufficient qualifications and experience and be up-to-date with relevant developments
- Be able to consult with specialists subject to a board - approved process
- Oversee integrated reporting (ie the integrity of the integrated report, its financial statements and the disclosure of sustainability for consistency with the financial information)

- Recommend engaging an external assurance provider on material sustainability issues
- Consider the need to issue interim results
- Review summarised information and engage external auditors to provide assurance on summarised financial information
- Ensure there is a combined assurance approach for assurance activities to address all significant risks
- Monitor the relationship between external assurance providers and the company
- Review annually and satisfy itself on the company's finance function and disclose such in the integrated report
- Oversee internal audit, (including appointment/dismissal and performance management of the Chief Audit Executive (CAE), approve the internal audit plan, evaluate the documented review of internal financial controls, assess internal audit performance and quality review the function, ensure properly resourced with sufficient budget)
- Recommend the external audit appointment and oversee the external audit process (nomination, terms of engagement, remuneration, monitoring independence, defining non-audit services policy and pre-approval of non-audit services, be informed of reportable irregularities, and review quality and effectiveness of external audit process)
- Report internally to the board and externally to shareholders on:
 - the discharge of its statutory duties
 - independence of external auditor
 - financial statements and accounting practices
 - effectiveness of the internal financial controls
 - its role, composition, meetings and activities
- Recommend the integrated report for approval by the board.

Risk management

The board is responsible for the governance of risk (to be specified in the board charter). The board responsibilities include the following:

- Develop a documented risk management policy and plan, approved by the board, which policy is widely distributed
- Comment in the integrated report on the effectiveness of the risk management system and process
- Review implementation of the risk management plan at least annually, with continuous monitoring
- Determine levels of risk tolerance (annual risk tolerance to be set with risk limits and appetites)
- Appoint a risk committee which considers the risk policy, plan and monitoring. The risk committee may comprise a minimum of three members from executive directors, non-executive directors, senior management and independent risk experts. It should meet at least twice a year
- Evaluate the performance of the risk committee
- Delegate to management the responsibility for the risk management plan
- Ensure that risk assessments are performed on a continual basis at least once a year in a top-down approach
- Receive and review the company's risk register (quantified, where possible)
- Ensure a framework for anticipating unpredictable risks
- Ensure management continually implements appropriate risk management responses with risk monitoring
- Receive assurance on the effectiveness of risk management from management as well as a written assessment of the effectiveness of the system of internal controls and risk management from internal audit
- Disclose in the integrated report its view on the effectiveness of the risk management process and any unusual risks.

Information Technology (IT)

The board is responsible for (IT) governance.

The board should:

- Ensure IT is on the agenda, an IT charter exists, IT policies are in place, an IT internal control framework exists and independent assurance on effectiveness of IT controls is obtained
- Align IT to performance and sustainability objectives of the company
- Delegate responsibility for implementation of an IT governance framework to management (The board may appoint an IT steering committee. The CEO should appoint a suitably qualified Chief Information Officer)
- Monitor and evaluate significant IT spend in terms of value and return on investment
- Ensure protection of intellectual property, information management and security (including personal data) on IT systems
- Ensure compliance with IT laws and standards
- Obtain independent assurance on IT governance and controls on outsourced IT services.

Management should demonstrate adequate disaster recovery arrangements.

The risk committee should ensure that IT risks are adequately addressed and get appropriate assurance on controls.

The audit committee should consider IT in relation to financial reporting and the going concern.

King III - Quick Reference Guide

Compliance

Compliance should form an integral part of the risk management process. The risk of non-compliance should be identified, assessed and responded to in the risk management process. The establishment of a compliance function should be considered.

The board should:

- Ensure the company complies with applicable laws and considers adherence to rules, codes and standards
- Delegate to management the implementation of an effective compliance framework and processes (this may include an approved compliance policy, code of conduct, structures, training, appointment of a compliance officer, key performance indicators, integration with risk management and ethics programmes)
- Monitor compliance and have it as a regular item on the board agenda
- Receive assurance on the effectiveness of compliance controls
- Disclose details on how it has established an effective compliance framework and processes, as well as disclose material or often repeated instances of non-compliance.

Internal audit

The board should ensure that there is an effective risk based internal audit function which is governed by an internal audit charter approved by the board and which adheres to the IIA Standards and code of ethics.

Internal audit should:

- Report functionally to the audit committee (CAE should report functionally to the audit committee chairman) and report at all audit committee meetings
- Evaluate the company's governance processes

- Objectively assess the effectiveness of risk management and the internal control framework
- Analyse business processes and controls
- Provide information on fraud and unethical practices
- Have an internal audit plan that is informed by the strategy and risks
- Be independent from management and objectives
- Provide a written assessment on the effectiveness of the company's system of internal controls and risk management to the board
- Provide a written assessment of the internal financial controls to the audit committee (after formally documenting and testing internal financial controls annually).

The CAE should be able to attend all executive committee meetings, and should develop a quality assurance and improvement programme.

Stakeholder management

The board should:

- Appreciate that stakeholder perceptions affect reputation and should seek to manage reputation risk
- Identify important stakeholders
- Delegate to management the responsibility to deal with stakeholder relationships
- Consider publishing stakeholder policies
- Oversee the mechanisms and processes for the constructive engagement of stakeholders
- Encourage shareholders to attend the Annual General Meeting
- Disclose in the integrated report its stakeholder dealings
- Strive to achieve balancing of various stakeholders legitimate expectations in the best interests of the company
- Ensure equitable treatment of shareholders of the same class and protection of minority shareholders
- Adopt communication guidelines for stakeholder communication so

communication is clear, relevant, timely, honest and accessible to stakeholders

- Consider disclosing in the integrated report the number of refusals to information access in terms of the Promotion of Access to Information Act 2 of 2000
- Adopt a formal dispute resolution process
- Select the appropriate individuals for Alternate Dispute Resolution (ADR) representation.

Integrated reporting and disclosure

The board should:

- Ensure integrity of integrated reporting. There should be controls to ensure integrity of the integrated report. The report should be prepared annually, cover sufficient financial and sustainability performance, focus on substance over form and describe how the company made its money
- Delegate evaluation of sustainability disclosures to the audit committee
- Comment on the financial results
- Disclose if the company is a going concern
- Convey positive and negative impacts of operations and how these will be improved in the next year
- Delegate oversight and reporting of sustainability to the audit committee (who should ensure that sustainability reporting and disclosure is independently assured).

Conclusion

King III is an aspirational code and it is likely that entities could take several years to apply all the principles and best practice recommendations. The challenges are in deciding the optimal level of application, balancing the costs and benefits to all stakeholders, and being able to disclose such principles and practices in a manner that is clear and understandable to stakeholders.



Contact us:



Granville Smith

Internal Audit, Risk & Compliance
Services (IARCS), South Africa
T: +27 (0) 82 374 5234
E: granville.smith@kpmg.co.za

Kerry Jenkins

Regulatory compliance and
governance services (IARCS),
Johannesburg
T: +27 (0) 83 297 1197
E: kerry.jenkins@kpmg.co.za

Paresh Lalla

Internal Audit, Risk & Compliance
Services (IARCS), Pretoria
T: +27 (0) 83 276 5373
E: paresh.lalla@kpmg.co.za

Glenn Ho

Internal Audit, Risk & Compliance
Services (IARCS), Cape Town
T: +27 (0) 21 408 7332
E: glenn.ho@kpmg.co.za

Ugen Moodley

Internal Audit, Risk & Compliance
Services (IARCS), Durban
T: +27 (0) 31 327 6000
E: ugen.moodley@kpmg.co.za

Frank Rizzo

IT Advisory, Johannesburg
T: +27 (0) 11 647 7388
E: frank.rizzo@kpmg.co.za

Paul Daly

Legal, Johannesburg
T: +27 (0) 11 647 5790
E: paul.daly@kpmg.co.za

Shireen Naidoo

Sustainability
T: +27 (0) 83 381 9235
E: shireen.naidoo@kpmg.co.za

Ritesh Narsai

Board Advisory Services (IARCS),
Johannesburg
T: +27 (0) 82 719 0253
E: ritesh.narsai@kpmg.co.za

Marlene Pappas

Contract Compliance (IARCS),
Johannesburg
T: +27 827 192061
E: marlene.pappas@kpmg.co.za

Mark Hoffman

Integrated Reporting
T: +27 (0) 11 647 7091
E: mark.hoffman@kpmg.co.za

Thingle Pather

Department of Professional Practice
T: +27 (0) 11 647 5037
E: thingle.pather@kpmg.co.za

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