



Janette Minnaar

**DEVELOPMENTS IN THE KING 3 REPORT
ON CORPORATE GOVERNANCE
AND THE COMPANIES ACT OF 2008**

AHI

June 2009



Developments since King 2

- The expectations of stakeholders have risen considerably.
- The scope of affairs to be managed actively has increased, for example, doing business globally, the interests of local communities, environmental constraints and responsibilities, fair labour and consumer practices and human rights issues.
- High-profile corporate failures, for example, in the banking sector, have done further harm to employees and investors, and there has been growing distrust in companies' integrity and leadership.

Legislative context of corporate governance

- Good governance and the law are intricately linked. The starting point of any analysis of this topic is that directors and management must discharge their legal duties.
- Criteria of good governance, governance codes and guidelines will be relevant in the determination of what is regarded as an appropriate standard of conduct.
- 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**.



Legislative context of corporate governance (4)

- The arguments against a legal framework are convincing – it is expensive and time consuming, one size does not always fit all, and the focus is moved from enterprise to compliance.
- Business is about taking risk for reward, thereby increasing the economic value of the company.
- A code of principles gives more flexibility.
- The King 3 code is based on the “apply or explain” basis. In other words, directors must apply the suggested code of principles, or explain their reasons for not doing so.

Compliance with laws, regulations, rules and standards (King 3 - chapter 7)

- Companies should comply with laws, regulations and applicable industry requirements.
- Companies should adhere to applicable non-binding rules and standards if such adherence would result in good governance and best practice.
- The board and each individual director should be aware of the laws, regulations, rules and standards applicable to the company.
 - The board must ensure that processes are in place for it to be informed timeously (part of induction, risk management and continued education); and
 - directors should have a sufficient understanding of the applicable content of the laws.

Compliance with laws, regulations, rules and standards (2)

- The board is responsible for the company's compliance with laws and should ensure that it implements an effective compliance framework and processes. A proactive approach should be adopted and should involve:
 - Assessment of compliance with laws;
 - delegation to a board committee when appropriate;
 - inclusion of compliance as a standing item on agenda;
 - development and implementation of a compliance policy by management and reporting to the board;
 - adoption of specific codes of practice in order to entrench a culture of compliance;
 - development of a culture of compliance through, for example, key performance indicators.

Compliance and risk management

- Compliance forms part of risk management (King 3, chapter four).
 - The head of compliance must be experienced;
 - should be supported by adequate resources; and
 - report directly to the board or executive management.
- Risks of non-compliance are, for example, damage to:
 - Business model; objectives, reputation, finances and stakeholder relationships.
- Risks should be identified through assessment and evaluation.
- Risks should be managed appropriately.



Corporate governance forum

- King 3 has set up a corporate governance forum, consisting of practitioners of law, who combine knowledge to write papers assisting in matters of governance.
- The Institute of Directors (IoD) has undertaken to prepare “best-practice papers” which will be published on the IoD website.



Key principles of King 3



Company secretaries

- Every public company and State-owned company must have a company secretary, who has specific duties set out in the Companies Act of 2008. King 3 deals with the duties of the company secretary in Chapter 1.



Integrated sustainability reporting (Chapter 6)

- King 3 requires companies to issue an integrated sustainability report, thereby increasing the trust and confidence of a company's stakeholders and the legitimacy of its operations.
- A KPMG international survey for 2008 shows that over 80 per cent of the global Fortune companies now have sustainability performance reports.
- Governance, strategy and sustainability are seen as inseparable, hence the phrase “integrated performance and reporting” used in King 3.
- Integrated reporting enhances risk management and encourages a company to evaluate its ethics and values.
- Nature, society, and business are interconnected in complex ways, which need to be understood by decision makers.

Integrated sustainability reporting (2)

- Sustainability reporting is in need of renewal in order to respond to:
 - The lingering distrust among civil society of the intentions and practices of big business; and
 - concerns among business decision makers that sustainability reporting is not fulfilling their expectations in a cost-effective manner.
- Leadership is expected to integrate strategy, sustainability and control (integrated governance) and establish the values and ethics that underpin sustainable practices.



Integrated sustainability reporting (3)

The principles underlying sustainability reporting are:

- Effective communication with stakeholders is essential:
 - Proactive and transparent communication on material matters;
 - report on economic, social and environmental issues;
 - inclusion of forward-looking information to enable stakeholders to make an informed assessment of the economic value of company, as opposed to its book value; and
 - communication should be relevant and material, in simple clear language.
- Effective reporting should take place at least once a year.

Managing stakeholder relationships (Chapter 8) Alternative dispute resolution (ADR)

- Because of the electronic ease with which companies can enter into contracts, there is a growing global recognition that alternative dispute-resolution (ADR) clauses are needed in contracts.
- A formal process should be established to resolve internal and external disputes.
- Mediation is being used not only as a dispute-resolution mechanism, but as a management tool.
- It is accepted worldwide that ADR is not a reflection on a judicial system of any country, but has become an important element of good governance.
- Directors have a duty of care to preserve business relationships. Consequently, when a dispute arises, they should endeavour to resolve it expeditiously, efficiently and effectively.

Alternative dispute resolution (ADR) (2)

- Mediation also enables novel solutions, which a court may not achieve, being constrained to enforce legal rights and obligations.
- In mediation, the parties' needs, rather than their rights and obligations, are considered.
- When mediation fails, an expedited arbitration process should be followed.



Audit Committees (Chapter 3)

- King 3 gives comprehensive detail on the composition and functions of audit committees.
- Section 94(7)(i) of the Companies Act prescribes that the Audit Committee of a company may be required to:
Perform other functions determined by the board, including the development and implementation of a policy and plan for a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes within the company.
- Although the Companies Act does not lay down qualifications for members of the audit committee, King 3 does recommend a basic level of qualification and experience for audit committee membership.

Responsibilities of auditors

- The designated auditor may not be such for more than five consecutive years and, in general terms, cannot perform any services that would be implicated in the conduct of the audit or determined by the audit committee.
- Every public company and State-owned company must appoint an audit committee, the duties of which are described in the Companies Act and repeated in Chapter 3 of King 3.
- The board must ensure that there is an effective risk-based internal audit function.



Internal audit (Chapter 5)

- The internal audit function is seen as a risk-centric function.
- Risk involves operational, strategic, financial and sustainability issues. Strategy in itself involves risk, because one is dealing with future events.
- A risk-based (as opposed to a compliance-based) approach to internal audit allows internal audit to find out whether internal controls are adequate for the risks that arise from the strategic direction that a company, through its board, has decided to adopt.
- Internal audit must provide a written assessment of the effectiveness of the system of internal control, performance and risk management to the board.
- The audit committee needs to report fully to the board on its conclusion arising from the internal audit assessment. This will give substance to the directors' endorsement of the adequacy of internal controls in a company.

Risk management (Chapter 4) IT governance

- The risks involved in information technology (IT) governance have become significant. IT governance is dealt with in detail in King 3 for the first time.
- There are operational risks when one has a service provider, because confidential information leaves the company. In IT governance, one seeks confidentiality; integrity and availability of the functioning of the system; possession of the system; authenticity of system information; and assurance that the system is usable and useful.
- Concerns are unauthorised use, access, disclosure, disruption or changes to the information system.
- In exercising their duty of care, directors should ensure that prudent and reasonable steps have been taken in regard to IT governance.

Corporate citizenship: leadership, integrity and responsibility (Chapter 2)

- As stated earlier, good corporate governance is essentially about effective and responsible leadership, which calls for integrity, transparency and accountability.
- It is the duty of company leaders to define a company's strategy, provide direction and establish the ethics and values that will influence and guide practices and behaviour to achieve sustainable performance.
- Ethics (integrity and responsibility) is the foundation of and reason for corporate governance.



Corporate citizenship: leadership, integrity and responsibility (2)

- The ethics of governance requires the board to ensure that the company is run with integrity and ethically in a transparent and accountable manner.
- As this is achieved, the company earns the necessary approval – its licence to operate – from those who are affected by, and who affect , its operations.
- All the typical aspects of corporate governance rest on a foundation of ethical values or standards. As such, corporate governance is an expression of ethical values and standards.

Ethics developments since King 2

- Increasingly, companies have realised that the true objective of ethics management is to create and sustain an ethical corporate culture, which ensures that its internal and external stakeholders are treated with respect and that its operations are ethically sound.
- The board should actively manage a company's ethics performance, thereby also ensuring that the company's reputation is protected.



Governance of ethics

- Ethics in business is connected with corporate governance in two ways, namely, the “*ethics of governance*” and “*the governance of ethics*”.
- The “*ethics of governance*” means that every aspect of corporate governance is a response to the moral imperative and responsibility to create and maintain an ethical company, or be a good corporate citizen.
- The “*governance of ethics*” concerns the management of ethics performance in the company by means of a corporate ethics-management programme.

Source: Prof Willem Landman, CEO, Ethics Institute of SA

Governance of ethics (2)

- Ethical (or unethical) behaviour and the right choices have a direct impact on the long-term sustainability of companies.
- In recent surveys by KPMG and the United Nations Environmental Programme, it was shown that the most important priority to stakeholders of a company is the quality of the company's product or service and that the second priority is the trust and confidence that the stakeholders have in the company.



Implement an ethics management programme

- Assess the organisational culture.
- Develop or redesign a code of ethics/practices.
- Institutionalise ethics e.g. establish an ethics office and a reporting line/hotline.
- Train all employees (including managers and board members).
- Audit effectiveness.
- Report to stakeholders.



Imperatives for good governance

- King 3 believes that reputation is a company's most important asset.
- In KPMG Forensics' 2008-2009 "Integrity Survey", which was done in the USA*, it was found that:
 - Nearly three of four employees (74 per cent) had personally observed, or had first-hand knowledge of, wrongdoing in the organisations within the past 12 months.
 - Forty-six (46) per cent of employees believed that the misconduct could cause "**a significant loss of public trust**" if discovered.

**Note: Sixty-six (66) per cent of the respondents had an international geographic presence.*

Imperatives for good governance (2)

- According to KPMG Forensics' Integrity Survey of 2008–2009, the major drivers of fraud and misconduct were:
 - Work pressure (50 per cent said managers and employees would do WHATEVER it took to meet business targets);
 - incentives (52 per cent of respondents believed they would be rewarded for RESULTS, not the MEANS used to achieve them);
 - inadequate resources to meet targets/perform the job; and
 - job insecurity.



Ethics of governance - King 3

The ethics of governance requires all decisions and actions of the board and executive management to be based on four basic ethical values (RAFT), which underpin good corporate governance:

- **Responsibility:** The board should assume responsibility for the assets and actions of the company and be willing to take corrective actions to keep the company on its strategic path.
- **Accountability:** The board should be able to justify its decisions and actions to shareholders and other stakeholders who require it to do so.
- **Fairness:** In its decisions and actions, the board should ensure that it gives fair consideration to the interests of all stakeholders of the company.
- **Transparency:** The board should disclose information in a manner that enables stakeholders to make an informed analysis of the company's performance.

The logo consists of the letters 'JM' in a white, stylized, cursive font, set against a red background that has a white, curved shape on its right side.

Janette Minnaar

Duties of directors

**Common law, King reports and
the Companies Act of 2008**

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Duties of directors Companies Act of 2008

- In addition to their common-law duties, directors are obliged to comply with the statutory duties imposed by the Companies Act of 1973 and the Corporate Laws Amendment Act of 2006 (promulgated on 14 December 2007).
- The new Companies Act of 2008 (which will come into effect in April 2010) will replace both acts.
- The Companies Act of 2008 has now codified the common-law duties of directors.
- Additions in the Companies Act, however, extend directors' duties and liabilities to raise directors' accountability to shareholders. These provisions are in addition to, not a substitute for, a director's common-law duties.

Duties of directors Companies Act of 2008 (2)

- In the Companies Act of 2008, directors are defined widely.
“**Director**” includes an alternate director, and—
 - (a) a prescribed officer; or
 - (b) a person who is a member of a committee of a board of a company, or of the audit committee of a company, irrespective of whether or not the person is also a member of the company’s board.
- At present, a prescribed officer is NOT defined in the Act (will be defined by regulation at later stage).

Duties of directors Companies Act of 2008 (3)

- The duties of directors can be grouped into:
 - (1) the **duty of care, skill and diligence**, in terms of which directors must manage the business of the company as a **reasonably prudent person** would manage his/her own affairs.
 - This standard of care is a mixed objective and subjective test, in the sense that the minimum standard is that of a reasonably prudent person, but a director who has greater skills, knowledge or experience than the reasonable person must give to the company the benefit of those greater skills, knowledge and experience;

and

Duties of directors Companies Act of 2008 (4)

- (2) **fiduciary duties**, being the duty to act in the best interest of the company, to avoid conflicts, not to take corporate opportunities or secret profits, not to fetter their votes and to use their powers for the purpose conferred and not for a collateral purpose.
- There is personal liability for breach of certain statutory duties.
 - Provision exists for relieving directors of liability in certain circumstances (he/she was reasonable and not conflicted), but not in the case of gross negligence, wilful misconduct or breach of trust.

Liability of directors Companies Act 2008

Section 77(9): In any proceedings against a director, other than for wilful misconduct or wilful breach of trust, the court may relieve the director, either wholly or partly, from any liability set out in this section, if it appears to the court that—

- (a) the director is or may be liable, but has acted honestly and reasonably; or
- (b) having regard to all the circumstances of the case it would be fair to excuse the director.

- Thus in assessing the standard of appropriate conduct of a director or manager, a court will take into account all relevant circumstances, including what is regarded as the normal or usual practice in the particular situation (**reasonable person test**). (*Draft King 3*)

Indemnification and directors' insurance

- The Act allows a company to advance expenses to a director to defend litigation in any proceedings arising out of his/her service to the company, or directly or indirectly to indemnify him/her for such expenses.
- The company, however, may not indemnify a director for actions arising from gross negligence, wilful misconduct or breach of trust.



Delinquent directors Companies Act of 2008

- The Act contains a new concept, whereby a shareholder, director or prescribed officer may apply to the court to have a director declared delinquent or under probation under certain circumstances.
- In general terms, a declaration of delinquency subsists for the lifetime of the person declared delinquent, who may apply to court to have such order set aside.



In summary



Differences between King 2 and King 3 codes

King 2

1. Applies to listed companies, financial institutions and public companies.
2. Implemented on a comply or explain basis.
3. Requires the board to identify and monitor non-financial aspects relevant to business.
4. Mandates the board to ensure that the company complies with laws, regulation and codes of best business practice.

King 3

1. Applies to all businesses.
2. Implemented on an apply or explain basis.
3. Sustainability reporting now forms part of financial reports.
4. Mandates the board to ensure that the company commences business-rescue procedures if it is financially distressed.

Differences between King 2 and King 3 codes (2)

King 2

5. States a preference for a majority of non-executive directors of whom a sufficient number should be independent.
6. Information technology governance is not addressed.
7. Internal audit is recognised.

King 3

5. The majority of board should be non-executive directors, of whom a majority should be independent.
6. Information-technology governance addressed under audit committees and risk management.
7. The status of internal audit function is enhanced to incorporate risk-centric long-term planning.

Source

Source: Preface, King 3 – Draft Code of Governance Principles

The Draft King 3 report can be obtained by e-mail:

KingIII@iodsa.co.za

- ***NOTE: The Practice Notes supporting the King 3 Report and the Code will be released on 1 September 2009.***

