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Every decision counts

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Introduction
Boards of directors are confronted with many difficult decisions on a regular basis. The right choice is not always obvious. The King Report on Governance for South Africa 2009 (King III) provides a list of best practice principles to assist and guide directors to make the right choice for their company.

These principles have become an indispensable guide on Corporate Governance to directors, executives and regulators alike.

King III provides guidance to all corporate entities on various governance related aspects, including:
- Ethical leadership and corporate citizenship
- Boards and directors
- Audit committees
- The governance of risk
- The governance of information technology (IT)
- Compliance with laws, rules, codes and standards
- Internal audit
- Governing stakeholder relationships
- Integrated reporting and disclosure.

The focus of this overview is largely to highlight what is new in King III.

King III and the Companies Act
The new Companies Act codifies the standard for directors' conduct and regulates the liability of directors where the standard is not met. Directors are obliged to act in good faith, in the best interest of the company and with the required level of skill and diligence. These standards will be enforced by the Companies and Intellectual Property Commission, and shareholders and other stakeholders of a company will hold the company and its directors accountable.

In contrast, there is no statutory obligation on companies to comply with King III. The underlying intention of King III is not to force companies to comply with recommended practice (King II required companies to 'comply or explain'), but rather for companies to '**apply or explain**'. Directors are accountable for the governance and wellbeing of the company, and to the body of shareholders. Where directors opt not to implement the recommended practices as set out in King III, they should be able to explain their reasoning and motivation to the shareholders.

As directors can be held personally liable for non-compliance with their statutory duties as set out in the Companies Act, they need to ensure that each and every decision is taken with care. Indeed, **every decision counts!** Most, if not all of the recommended best practice principles set out in King III relate to the legislative duties of directors to exercise powers to perform their functions in good faith and for a proper purpose in the best interest of the company. In addition, they should do it with the degree of care, skill and diligence that may reasonably be expected of a director. As such, King III constitutes a valuable guide to directors and other office bearers to ensure compliance with the provisions of the Companies Act. It is recommended that directors pay close attention to the enumerated principles, and aim to apply all such principles. Of course, where they choose not to apply a particular principle, they should be able to explain that decision to shareholders.

Focus of King III
King II highlighted corporate citizenship and integrated sustainability, the so-called triple bottom line, in terms of which companies needed to account not only for economic and financial issues, but also for social and environmental issues. King III builds on this principle by emphasising sustainability. Directors have an accountability to shareholders and an obligation to all stakeholders (including shareholders) to ensure that the company's resources are utilised so as to ensure the continuing viability of the company. This involves not only environmental sustainability (resource management with an eye on future needs), but also issues such as social responsibility (ensuring a positive impact on the community within which the company operates), respect for human rights, and the effective management of stakeholder relationships (including the utilisation of alternative dispute resolution mechanisms to resolve potential disputes efficiently, expeditiously and inexpensively).

A focus on sustainability will not only positively impact a company's risk management, but also its strategic planning processes. Governance, strategy, risk, performance and sustainability have become intrinsically linked, and directors should ensure that the company's strategy accounts for sustainability issues. Directors also need to ensure adequate sustainability reporting to all stakeholders.

King III also points out that the economic value of a company can no longer be based on the balance sheet only. Rather, the economic value will be impacted by a range of non-financial issues such as brand and reputation, stakeholder relations and goodwill, an evolving and forward looking strategy, environmental sustainability, social responsibility, quality of governance, etc.

What's new in King III
Although the King III Report builds on the pertinent issues as raised in King I and King II, the promulgation of the Companies Act, as well as the focus on sustainability, necessitated the inclusion of or renewed emphasis on a number of issues.

These include:

Integration of strategy, sustainability and governance
A number of matters concerning the board and directors, such as the composition of the board, duties for the chairperson and the CEO, the board appointment process, director development, remuneration, and performance assessment of directors
Clearly defined role and functions of the audit committee
While not a new concept, emphasis on the risk based approach to internal audit and the strategic positioning of the internal audit function within the company
Inter-relation between risk management and the company's strategic and business processes
The concept of combined assurance
Alternative dispute resolution and stakeholder relationships
IT governance and IT risk management
Compliance with laws and regulations
Integrated reporting and disclosure

A number of issues discussed in King II have subsequently been incorporated in the Companies Act, and since these matters are now legislated, they are no longer expressly dealt with in King III. These matters include the business judgment rule, distinction between audit and non-audit services, enforcement of financial reporting standards, and the need for enforcement of the recommended principles.

Boards and directors
King III confirms the role of the Board as the focal point for corporate governance. The Board has collective responsibility to provide and ensure good governance. As such, it is the responsibility of the directors to ensure, among others, that the company:
- operates ethically and with integrity, and as a responsible corporate citizen
- considers the interests of the community within which it operates
- integrates governance, strategy, risk, performance and sustainability
- complies with laws and regulations
- identifies and manages risks
- employs structures and processes to ensure the integrity of its integrated reporting.

...directors are ultimately accountable for adherence to appropriate best practice principles...

Although the directors are ultimately accountable for adherence to appropriate best practice principles, the direct responsibility of the Board is focused on the design and adoption of adequate policies, inculcating the required culture to adhere to such policies, and the subsequent oversight of the implementation of such policies. Management bears responsibility for the implementation of policies, strategy, business plans and the like.

In order to ensure the effective functioning of the Board, King III proposes a unitary board structure comprising executive, non-executive and independent non-executive members. The majority should be non-executives, of whom the majority should be independent. The Board should be chaired by an independent non-executive director. The CEO of the company should not also fulfil the role of the Chair of the Board.

King III further proposes a formal election and induction process for new Board members, ongoing director development, and emphasises the importance of effective Board performance. It also provides guidance on remuneration of directors and executives, and the composition and responsibility of Board committees.

King III proposes that the Boards of all companies establish audit, risk, remuneration and nominations committees, and be assisted by a competent company secretary.

Audit committee

Although the Companies Act prescribes the composition and functions of the audit committee for state owned and public companies, King III proposes that all companies should appoint an audit committee. The audit committee should comprise at least three members and all members should be independent non-executive directors. The committee as a whole should have sufficient qualifications and experience to fulfil its duties, and should be permitted to consult with specialists or consultants after following an agreed process. The terms of reference of the audit committee should be approved by the Board.

The functions of the audit committee in relation to the external auditor include:

- the nomination of the external auditor for appointment and to verify the independence of the auditor
- determining the audit fee and the scope of the appointment
- ensuring that the appointment complies with the requirements of the Companies Act
- determining the nature and extent of non-audit services
- pre-approving any contract for non-audit services.

The Board may delegate certain aspects of risk management and sustainability to the audit committee. King III introduces the concept of integrated reporting (which combines financial and sustainability reporting) and allows for the Board to delegate the review of integrated reporting to the audit committee. In this regard, the audit committee should recommend to the Board the need to engage external assurance providers to provide assurance on the accuracy and completeness of material elements of integrated reporting.

King III adopts a wide approach to the audit committee's responsibility for financial risk and reporting to include:

- Financial risks and reporting
- Review of internal financial controls
- Fraud risks and IT risks as it relates to financial reporting.

King III further introduces the combined assurance model. In terms of this model, assurance should be done on three levels, i.e. management, internal assurance providers and external assurance providers. The audit committee should ensure that a combined assurance model is applied to provide a coordinated approach to all assurance activities.

Internal audit

King III advocates a risk based approach to internal audit. In order for internal audit to contribute to the attainment of strategic goals, the internal audit function should be positioned at a level within the company to understand the strategic direction and goals of the company. It should develop a programme to test the internal controls vis-a-vis specific risks. The internal audit function should provide assurance with reference to the adequacy of controls to identify risks that may impair the realisation of specific goals as well as opportunities that will promote the achievement of the company's strategic goals.

As an internal assurance provider internal audit should form an integral part of the combined assurance model. It should provide a written assessment of internal controls and risk management to the Board, and specifically on internal financial controls to the audit committee.

The right choice is not always obvious...

Governance of risk

King III emphasises the fact that risk management should be seen as an integral part of the company's strategic and business processes. The Board's responsibility for governance of risk should be set out in a risk management policy and plan. The Board should consider the risk policy and plan, and should monitor the whole risk management process.

While the Board remains responsible for the risk management policy and the determination of the company's risk appetite and risk tolerance, management is responsible for the design, implementation and effectiveness of risk management.

The Board should receive combined assurance regarding the effectiveness of the risk management process.

The Board may assign its responsibility for risk management to the risk committee. Membership of this committee should include executive and non-executive directors. Where the company decides to assign this function to the audit committee, careful consideration should be given to the resources available to the audit committee to adequately deal with governance of risk in addition to its audit responsibilities.

Stakeholder management and alternative dispute resolution

King III proposes that companies institute measures to ensure that they are able to proactively manage the relationships with all their stakeholders, including shareholders. The company should encourage constructive stakeholder engagement. The Board should strive to achieve the correct balance between the interests of all its various stakeholder groupings and promote mutual respect between the company and its stakeholders.

Alternative dispute resolution has become a trend worldwide, and not merely an alternative to the judicial system. Rather, alternative dispute resolution can be used as a management tool to manage and preserve stakeholder relationships and to resolve disputes expeditiously and inexpensively. This approach is in line with the directors' duty to act in the best interest of the company and their duty of care. The inclusion of dispute resolution clauses in contracts, as well as the utilisation of formalised alternative dispute resolution channels, is recommended.

IT governance

As information and technology systems have become such an integral part of doing business, King III provides specific guidelines to ensure effective IT governance. It is necessary for directors to ensure proper IT governance, the proper alignment of IT with the performance and sustainability objectives of the company, and the proper management of operational IT risk, including security.

The risk committee may be assigned responsibility to oversee the management of IT risk. In addition, the audit committee should consider IT as it relates to financial risk and reporting.

Compliance with laws, rules, codes and standards

The Board is responsible for overseeing the management of the company's compliance risk. The Board should ensure awareness of and compliance with laws, rules, codes and standards throughout the business. In turn, management is responsible for the implementation of an effective compliance framework and processes, and for the effective management of the company's compliance risk. The Board may mandate management to establish a compliance function to implement measures and procedures to ensure that the Board's policy on compliance is implemented.

Integrated reporting and disclosure

King III proposes integrated reporting to ensure that all stakeholders are able to assess the economic value of the company. This entails the integration of the company's financial reporting with sustainability reporting and disclosure. The Board should ensure that the positive and negative impacts of the company's operations, as well as plans to improve the positives and eradicate the negatives, are conveyed in the integrated report. King III suggests that the Board may delegate oversight of the integrated report to an appropriate committee (either the audit committee or a sustainability committee). The audit committee should oversee the provision of independent assurance over sustainability issues and should assist the Board by reviewing the integrated reporting and disclosure to ensure that it does not contradict financial reporting.

Timeline for implementation

The King III report was released on 1 September 2009. Practice Notes will be published from time to time to provide guidance with regard to specific issues.

King III will be effective from 1 March 2010.

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