



INSTITUTE OF DIRECTORS
SOUTHERN AFRICA

State-owned companies: Companies Act, PFMA and King III in perspective

Public Sector Working Group: Position Paper 1

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Executive summary

Governance is essentially about effective leadership based on an ethical foundation. Compliance, as any other business activity, should take place within the context of leadership and sound governance principles.

The board of a company has a duty to ensure that the company complies with all applicable laws and rules. In addition, the board also has the responsibility to consider adherence to codes and standards. All these compliance responsibilities are very onerous and especially so where the state is involved. This is exacerbated by the fact that different single provisions in laws, rules, codes and standards cannot be read in isolation, but need to be interpreted in the context of the whole compliance universe applicable to an entity.

The Companies Act, the PFMA and King III share many of the principles of good governance applicable to SOCs. Alignment is possible and should in fact be strived for in the spirit of the overarching governance principles of accountability, fairness, transparency and responsibility.



When attempting to resolve areas of conflicts, it is to be noted that the PFMA prevails. We submit, however, that this is only where there are irreconcilable differences. If it is for instance a case that the Companies Act has the “more onerous requirement”, then compliance with the Companies Act is necessary. This will then encompass compliance with the PFMA.

Reconciling the law (which must be adhered to) with governance recommendations (to be applied voluntarily) sometimes poses a challenge when there are indeed clear contradictions that cannot be reconciled. We submit that it will in these instances not be sufficient for the boards of SOCs to wash their hands off these matters as it is the focal point of governance and bears ultimately responsibility. What is required firstly, is that SOC boards play an active role in advocating changes to bring about amendments to enabling legislation that are in line with sound governance principles.

Secondly, until such changes are effected, SOC boards should attempt to work within legislative constraints to bring about a sound governance outcome. For instance, if enabling legislation requires the executive authority to appoint the CEO as opposed to the appointment being made by the board (as required by King III), the board should actively engage the executive authority on this issue in order to bring its input to bear on the executive authority’s decision as to who to appoint. The board should understand that the risk that King III is managing in recommending that the board appoints the CEO, is that there may be confusion around accountability and reporting lines if the executive authority makes this appointment. In recognition of this risk, the board could make it very clear in the employment agreement with the CEO that he or she is accountable and must report to the board. By being proactive in this way, an SOC board may then achieve the result that was envisaged by King III despite the fact that it needs to work within the constraints of legislation.

Other issues that are highlighted in this Position Paper are the following:

- Practice recommendations contained in King III and that are widely adopted by directors set a new benchmark for directors’ standard of conduct. When the “reasonable director” test is applied by the courts, this will be taken into account.

- The fiduciary duties of directors and management of conflicts of interest are expressed differently in the Companies Act, King III and the PFMA. However, there is no conflict and all of these provisions should be read together in order to adhere to the highest standard.
- The specific PFMA provisions that relate to the role and functions of the board can all be matched to an appropriate King III principle and SOC boards should interpret the legislation against the wider framework of King III.
- Even though there is a contradiction in the PFMA and the Companies Act on who elects the audit committee, it does not change the sound governance principle that SOC boards should be proactive in ensuring an effective and independent audit committee.
- The duties of the audit committee as set out in its terms of reference should encompass all of the duties contained in the Treasury Regulations, the Companies Act and King III in order to achieve the higher governance standard.
- Although not required in terms of applicable legislation, an SOC board should have regard to the recommendation in King III that the audit committee should base its report concerning the effectiveness of internal financial controls on a documented review conducted by internal audit.
- The audit committee of an SOC should fulfil the wider role in relation to the appointment of an auditor as recommended in King III.
- Reporting requirements for audit committees are more extensively provided for in King III than in the legislation. SOC audit committees should aspire to attain those higher reporting requirements.

1. Introduction

In this Position Paper we will focus specifically on key laws, rules, codes and standards that concern the governance of a state-owned company (SOC). The objective of this Position Paper is to highlight to boards of SOCs those areas in which governance and legislation intersect and to offer a position on how these varying and sometimes conflicting provisions could be reconciled. This is done by presenting a comparative analysis of the various provisions that deal with governance as contained in the Companies Act, No. 71 of 2008 (Companies Act), the Public Finance Management Act, No. 1 of 1999 (PFMA) and King III.

SOCs are subject to a bouquet of regulations – their regulatory universe. As the objective of this Position Paper is to provide a comparison of governance aspects as contained in the Companies Act, the PFMA and King III, it is necessary to identify which categories of entities would be subject to both the Companies Act and the PFMA.

The PFMA was promulgated in 1999 and became effective on 1 April 2000. The PFMA gave effect to the provisions in the Constitution of the Republic of South Africa, No. 108 of 1996, relating to national and provincial spheres of government. The PFMA “adopts an approach to financial management which focuses on outputs and responsibilities”.

The PFMA established the term “national government business enterprise” which is defined in section 1 as an entity which:

- a. is a juristic person under the ownership control of the national executive;
- b. has been assigned financial and operational authority to carry on a business activity;
- c. as its principle business, provides goods or services in accordance with ordinary business principles; and
- d. is financed fully or substantially from sources other than
 - i. the National Revenue Fund; or
 - ii. by way of tax, levy or other statutory money.

All national government business enterprises are by definition “national public entities” as described and referred to in the PFMA, of which some are companies and some not.

The Companies Act, 2008 (Companies Act) established the term “state-owned company” (SOC) which is defined in section 1 as:

...an enterprise that is registered in terms of this Act as a company, and either—

- a. falls within the meaning of “state-owned enterprise” (national government business enterprise) in terms of the Public Finance Management Act, 1999 (Act No. 1 of 1999); or
- b. is owned by a municipality, as contemplated in the Local Government: Municipal Systems Act, 2000 (Act No. 32 of 2000), and is otherwise similar to an enterprise referred to in paragraph (a);...

SOCs fall within the ambit of the PFMA, which means that they need to comply with additional provisions over and above those of the Companies Act.

In order to limit the range of variances in PFMA provisions to be used in this comparative analysis, SOC's not listed in schedule 2, 3B and 3D of the PFMA are not considered in this Position Paper, although as a consequence of their legal form, they are also required to comply with the Companies Act. The Companies Act also applies to companies regulated by the Local Government: Municipal Finance Management Act, No. 56 of 2003 (MFMA). The MFMA, specifically chapter 10, is based on the same principles of financial management contained in the PFMA, and is therefore not specifically dealt with in this Position Paper.



The release of the King Report on Governance for South Africa – 2009 (King III) brought with it significant opportunities for SOCs that embrace good governance. King III brings with it principles and recommendations that correlate with the requirements of the Companies Act and the PFMA.

2. Governance universe

The laws, rules, codes and standards that typically impact on SOCs’ governance in South Africa can be depicted schematically:

An SOC’s existence is normally based on legislation referred to as “enabling legislation”, which provides for its establishment, control, powers, function and funding. Whilst enabling acts are entity-specific, they are only referred to in this Position Paper but not dealt with in any detail.

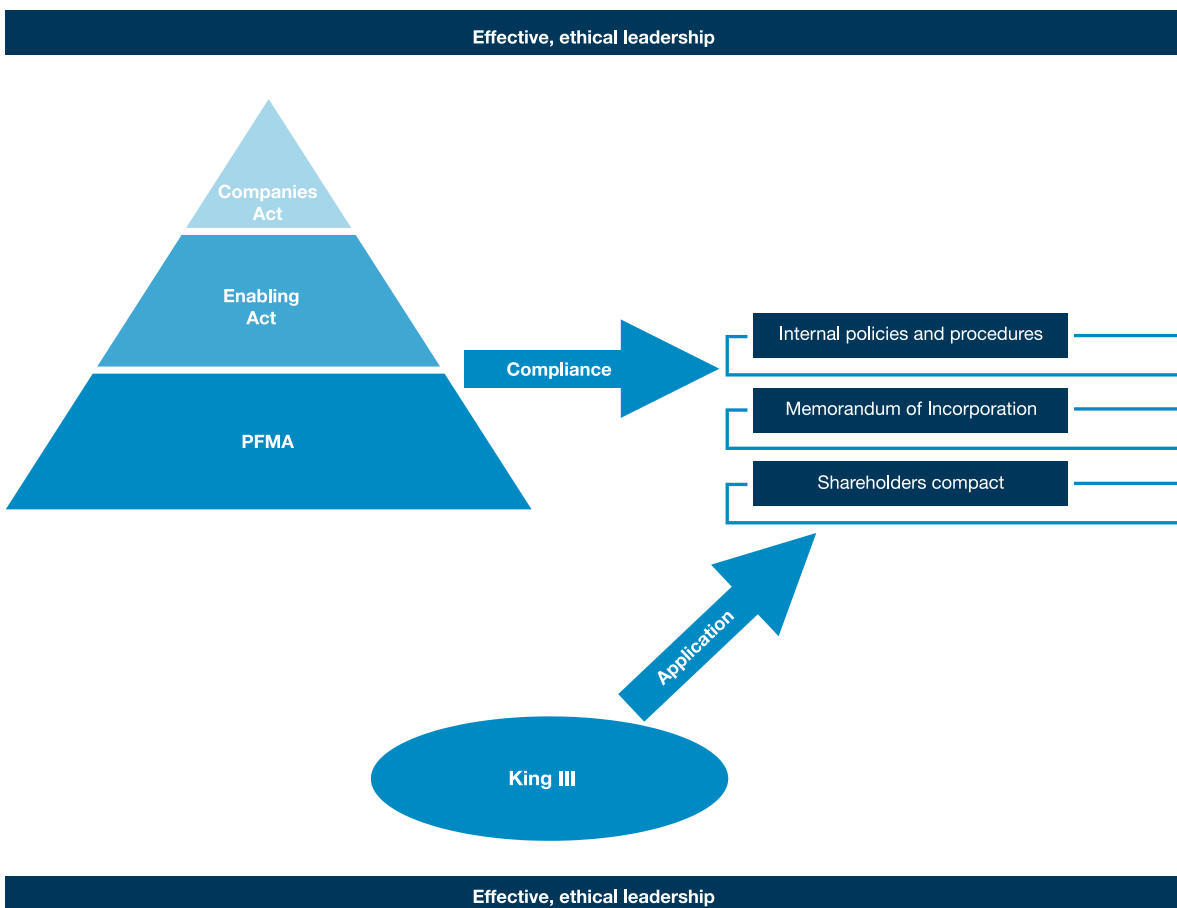
Chapter 6 of the PFMA, as well as other sections (1-4, 66-70, 76-77, 83-86 and 92-95) apply to public entities that include SOCs. In terms of section 76(4), “the National Treasury may make regulations” dealing with a number of specific matters. To this end, the Treasury Regulations (as amended) (issued on 15 March 2005) are relevant and are considered in this Position Paper.

The Companies Act applies to all companies, including SOCs.

Section 3(3) of the PFMA determines that if any conflict exists between the PFMA and another Act, the PFMA prevails.

The interrelationship between the PFMA and the Companies Act is evident from the similarity of its respective requirements imposed on directors and the boards of SOCs.

However, as a broad statement, it can be argued that the major differences lie in the fact that the PFMA focuses primarily on aspects of financial management within public entities, while the Companies Act covers matters in relation to companies that are wider in scope than simply financial management. These areas are discussed below.



3. Governance provisions in the Companies Act, PFMA and King III

A comparison of selected aspects of the Companies Act, PFMA and King III relevant to SOCs is provided to give some insight into the issues that need to be reconciled by SOC boards:

Companies Act	PFMA	King III	Comment
Accountability			
<p>Section 66 determines that an SOC must have a board, which has the authority to exercise all of the powers and perform any of the functions of the SOC except if limited by the Companies Act or memorandum of incorporation. The board of an SOC should comprise at least three directors.</p>	<p>Section 49 establishes the accountability of the board of an SOC.</p>	<p>Principle 2.1 requires that the board should act as the focal point for and custodian of corporate governance.</p> <p>Principle 2.18 states that the board should comprise a balance of power with a majority of non-executive directors. The majority of non-executive directors should be independent.</p>	<p>When King III is interpreted in relation to SOCs, it can be assumed that whenever there is reference to “the board”, it should be interpreted as referring to the accounting authority established in terms of the PFMA and enabling legislation.</p> <p>In terms of the Companies Act, the board has the “authority” as stated, whereas the focus of King III is on “responsibility”, which acts to enhance the authority aspect.</p> <p>The significance of King III to the board, acting as the focal point of governance, is that boards of SOCs should understand the specific responsibilities dealt with in the PFMA and Companies Act in terms of this governance principle.</p> <p>We submit that the Companies Act, PFMA and King III should be read together to achieve the highest standards of governance.</p>

Companies Act	PFMA	King III	Comment
Accountability			
			<p>For SOC boards to consider:</p> <ul style="list-style-type: none"> • Is there recognition of the fact that ultimate accountability for whatever happens in and with the SOC rests with the board? • Is there appreciation of the fact that a balance of power protects the board against the adverse consequences of the checks and balances not being in place?
Standards of directors' conduct and conflicts of interest			
<p>Section 76 sets out standards of directors' conduct in line with common duties, namely to act in good faith and for proper purpose, in the best interest of the company and with the expected degree of care, skill and diligence.</p> <p>Directors as defined have the following duties in relation to information obtained while acting in the capacity of a director:</p> <ul style="list-style-type: none"> • A director may not use his/her position or information obtained in his/her capacity as a director to gain advantage for himself/herself or for a person other than the SOC or its wholly-owned subsidiary or knowingly cause harm to the SOC or subsidiary company. The director must communicate to the board at the earliest opportunity, information that comes to the director's attention, unless it is immaterial to the SOC, generally available to the public or known to other directors, or there is an ethical or legal confidentiality obligation that prohibits disclosure of the information 	<p>Section 50 provides that the board of an SOC must:</p> <ul style="list-style-type: none"> • Exercise the duty of utmost care to ensure reasonable protection of the assets and records of the SOC; • Act with fidelity, honesty, integrity and in the best interests of the SOC in managing the financial affairs of the SOC; • On request, disclose to the Minister responsible for that SOC or the legislature to which the SOC is accountable, all material facts, including those reasonably discoverable, which in any way may influence the decisions or actions of the Minister or that legislature; and • Seek, within the sphere of influence of that board, to prevent any prejudice to the financial interests of the state. 	<p>Principle 2.14 states that the board must always act in the "best interests of the company".</p> <p>The interpretation of this phrase is elaborated upon and reference is also made to the two sets of common law duties of directors, namely to act with care, skill and diligence; and to act in good faith.</p> <p>Paragraphs 23-25 under this principle deal with directors' conflicts of interest. It is stated that the personal interests of a director or people associated with that director should not take precedence over the interests of the SOC.</p> <p>It is pointed out in King III that certain conflicts are so fundamental that they should be avoided entirely. Other conflicts are to be managed.</p>	<p>It is to be noted that the Companies Act sets out the standards of conduct in relation to individual directors, whereas the PFMA refers to the duties of the board as a whole. Furthermore, the duties are stated in the PFMA with a focus on financial management, whereas in the Companies Act, they centre on fiduciary duties and the duty to act with due care, skill and diligence.</p> <p>The duties outlined in the PFMA do not, in our view, exclude the provisions of the Companies Act, but should rather be seen as adding "specifics" to the overarching provisions of the Companies Act.</p>

Companies Act	PFMA	King III	Comment
Standards of directors' conduct and conflicts of interest			
<p>The other duties of a director are to act:</p> <ul style="list-style-type: none"> • In good faith and for proper purpose; • In the best interests of the SOC; and • With the degree of care, skill and diligence that may reasonably be expected of a person who carries out the same functions as a director in relation to the SOC and who has the knowledge, skill and experience of that director. <p>The obligations of acting in the best interest of the SOC and of care, skill and diligence as contemplated in section 3(b) and (c) are satisfied when a director:</p> <ul style="list-style-type: none"> • Has taken reasonable diligent steps to become informed; • Either had no material personal interest in the matter or complied with the provisions of section 75 of the Companies Act in this regard; and • Made or supported a decision and had a rational basis for believing, and did believe that the decision was in the best interests of the SOC. 	<p>A director of the board may not:</p> <ul style="list-style-type: none"> • Act in a way that is inconsistent with the responsibilities assigned to the board in terms of the PFMA; or • Use the position or privileges of, or confidential information obtained as, the board or a director, for personal gain or to improperly benefit another person. <p>The director must disclose to the board any direct or indirect personal or private business interest that, that member or any spouse, partner or close family member may have in any matter; and withdraw from the proceedings of the board when that matter is considered, unless the board decides that the member's direct or indirect interest in the matter is trivial or irrelevant.</p>		<p>The Companies Act provides for a number of subjective measures to determine whether directors have met the required standard of conduct. A number of phrases used in section 76 of the Companies Act highlight this: "that may reasonably be expected of a person"; "degree"; "reasonably diligent steps"; and "rational basis for believing". The practices recommended in King III will (as soon as it has become widely adopted) set the standard for directors' conduct and will be the measure for determining whether directors' conduct has met these subjective standards as described in the Companies Act. Directors should therefore understand that although King III contains voluntary practice recommendations, these could have far-reaching consequences in determining what is reasonable conduct for directors.</p> <p>For SOC boards to consider:</p> <ul style="list-style-type: none"> • Is there a conflict of interest policy in place that details conflict or interest procedures? • If so, is this policy ever evaluated to ascertain whether it achieves its objectives? • Do directors understand that the more established the governance practices recommended in King III become, the more likely a court would regard conduct that conforms to these practices as meeting the required standard of care?

Companies Act	PFMA	King III	Comment
Standards of directors' conduct and conflicts of interest			
<p>A director may rely on the information, recommendations, reports, etc. of the following persons:</p> <ul style="list-style-type: none"> • Employees of the SOC that the director reasonably believes to be reliable and competent; • Legal counsel, accountants or other professionals as to matters involving skills or expertise that the director reasonably believes are matters within the competence of that person and to which the person merits confidence; and • A board committee of which the director is not a member unless the director has reason to believe that the actions of the committee do not merit confidence 			<ul style="list-style-type: none"> • Do boards recognise that directors who are appointed as representatives of a party with an interest in the SOC, pose a potential for conflict and is this managed by the board?
Role and functions of the board			
<p>Section 66. (1) provides that the business and affairs of a company must be managed by, or be under the direction of, its board, which has the authority to exercise all of the powers and perform any of the functions of the company, except to the extent that this Act or the company's memorandum of incorporation provides otherwise.</p>	<p>Section 51 determines that the board of an SOC must ensure that it has and maintains:</p> <ul style="list-style-type: none"> • Effective, efficient and transparent systems of financial and risk management and internal control; • A system of internal audit under the control and direction of an audit committee complying with and operating in accordance with the Treasury Regulations and the PFMA; • An appropriate procurement and provisioning system which is fair, equitable, transparent, competitive and cost effective; 	<p>The role and functions of the board are set out as follows in King III:</p> <ul style="list-style-type: none"> • Principle 2.1: The board should act as the focal point for and custodian of corporate governance; • Principle 2.2: The board should appreciate that strategy, risk, performance and sustainability are inseparable; • Principle 2.3: The board should provide effective leadership based on an ethical foundation; • Principle 2.4: The board should ensure that the SOC is and is seen to be a responsible corporate citizen; • Principle 2.5: The board should ensure that the SOC's ethics are managed effectively; 	<p>The focus on financial management is clear from the nature of the general responsibilities of the accounting authority listed in the PFMA. King III casts the net wider to encompass a wider range of governance responsibilities.</p> <p>The specific PFMA provisions can all be matched to an appropriate principle of King III and we submit that the boards of SOCs adopt this approach.</p> <p>As far as the appointment of the chairman of the board and the CEO is concerned, the enabling legislation often provides that the shareholder or executive authority makes these appointments. This contradicts the recommendations of King III.</p>

Companies Act	PFMA	King III	Comment
Role and functions of the board			
	<ul style="list-style-type: none"> • A system for properly evaluating all major capital projects prior to a final decision on the project. <p>The board must take effective and appropriate steps to collect all revenue due to the SOC; prevent irregular expenditure, fruitless and wasteful expenditure, losses resulting from criminal conduct, and expenditure not complying with the operational policies of the SOC and manage available working capital efficiently and economically.</p> <p>The board is also responsible for the management and safeguarding of the assets and for the management of the revenue, expenditure and liabilities of the SOC.</p> <p>The board must comply with any tax, levy, duty, pension and audit commitments as required by legislation.</p> <p>The board must take effective and appropriate disciplinary steps against any employee of the SOC who contravenes or fails to comply with a provision of the PFMA; commits an act which undermines the financial management and internal control system of the SOC; or makes or permits an irregular expenditure or a fruitless and wasteful expenditure.</p> <p>The board is responsible for the submission by the SOC of all reports, returns, notices and other information to Parliament, and to the relevant Minister or Treasury, as may be required by the PFMA.</p>	<ul style="list-style-type: none"> • Principle 2.6: The board should ensure that the SOC has an effective and independent audit committee; • Principle 2.7: The board should be responsible for the governance of risk; • Principle 2.8: The board should be responsible for information technology (IT) governance; • Principle 2.9: The board should ensure that the SOC complies with applicable laws and considers adherence to non-binding rules, codes and standards; • Principle 2.10: The board should ensure that there is an effective risk-based internal audit; • Principle 2.11: The board should appreciate that stakeholders' perceptions affect the SOC's reputation; • Principle 2.12: The board should ensure the integrity of the SOC's integrated report; • Principle 2.13: The board should report on the effectiveness of the SOC's system of internal controls; • Principle 2.14: The board and its directors should act in the best interests of the SOC; • Principle 2.15: The board should consider business rescue proceedings or other turnaround mechanisms as soon as the SOC is financially distressed as defined in the Companies Act;. 	<p>For SOC boards to consider:</p> <ul style="list-style-type: none"> • Does the board follow a compliance approach to governance in which it only considers which provisions of the PFMA have been complied with, or does it consider the wider principles of governance, as espoused in King III? • In the event that the board does not appoint its chairman and CEO, does it make recommendations to the shareholder and executive authority in this regard?

Companies Act	PFMA	King III	Comment
Role and functions of the board			
	<p>The board must promptly inform the National Treasury of any new entity which that SOC intends to establish, or in the establishment of which it takes the initiative and allows the National Treasury a reasonable time to submit its decision prior to formal establishment; and</p> <p>The board must comply, and ensure compliance by the SOC, with the provisions of this Act and any other legislation applicable to the SOC.</p>	<ul style="list-style-type: none"> • Principle 2.16: The board should elect a chairman of the board who is an independent non-executive director. The CEO of the SOC should not also fulfil the role of chairman of the board; and • Principle 2.17: The board should appoint the chief executive officer and establish a framework for the delegation of authority. 	
Election of audit committees			
<p>Audit committee members must be elected by the shareholders at the AGM.</p>	<p>The board must establish an audit committee (per Treasury Regulation 27.1.1), while audit committees may also be shared between an SOC and its subsidiaries.</p>	<p>Principle 3.1 determines that the board should ensure that the SOC has an effective and independent audit committee.</p>	<p>The provisions of the Companies Act conflict with those of the PFMA concerning who elects the members of the audit committee. Section 3(3) of the PFMA determines that if any conflict exists between the PFMA and another Act, the PFMA prevails.</p> <p>We submit that the objective of all these provisions is to ensure an effective and independent audit committee. Even if the board does not elect the audit committee, it needs to play a role in making sure that the audit committee is effective.</p> <p>Similarly, if the board is responsible for electing the audit committee (say by virtue of its enabling legislation), it needs to follow a process that will safeguard the independence of the audit committee.</p> <p>For SOC boards to consider:</p> <ul style="list-style-type: none"> • Is the board proactive in ensuring an effective and independent audit committee?

Companies Act	PFMA	King III	Comment
Members of the audit committee			
<p>Membership requirements are stipulated in section 94(2) and (4), but determines that membership of the committee must consist of at least three members who are directors of the SOC and independent as described.</p> <p>Section 94 specifies that each member of an audit committee must be a director of the SOC, who satisfies any requirements the Minister may prescribe as necessary to ensure that any such committee, taken as a whole, comprises persons with adequate relevant knowledge and experience. Such members may not be executives (current or previous financial year) in the employ (current or past three years) of the SOC, a material supplier or customer of the SOC. The requirement to be independent and objective will also exclude from membership persons who are related to persons who meet the criteria in the previous sentence.</p> <p>Any vacancy on the audit committee must be filled within 40 business days after the vacancy arises.</p>	<p>Section 77 states that the audit committee should comprise at least three persons and must meet at least twice a year.</p> <p>Treasury Regulation 27.1.4 states that the majority of the members of an audit committee shall consist of non-executive members appointed by the board, although committee members need not all be members of the board. The majority of persons serving on an audit committee must be financially literate.</p> <p>Furthermore, Treasury Regulation 27.1.3 stipulates that the chairperson of the audit committee must be independent, be knowledgeable of the status of the position, have the requisite business, financial and leadership skills and may not be the chairperson of the board or a person who fulfils an executive function in the SOC.</p> <p>The Minister must concur with any premature termination of services of a member of the audit committee.</p>	<p>Principle 3.2 advocates that all members of the audit committee of an SOC must be suitably skilled and experienced independent non-executive directors.</p> <p>Under this principle, the collective skills required of the audit committee are listed as follows:</p> <ul style="list-style-type: none"> • Integrated reporting, which includes financial reporting; • Internal financial controls; • External audit process; • Internal audit process; • Corporate law; • Risk management; • Sustainability issues; • Information technology governance as it relates to integrated reporting; and • The governance processes within the SOC. <p>The board must appoint a person to fill a vacancy on the audit committee should such a vacancy arise. Such an appointment must be ratified by the shareholders at the subsequent AGM.</p> <p>Principle 3.3 also requires that the audit committee should be chaired by an independent non-executive director.</p>	<p>The requirement that audit committee members be independent is more explicit in the Companies Act and King III than in the PFMA.</p> <p>In this instance, it is not a matter of conflicting provisions, but rather that King III and the Companies Act set the higher governance standard. It will in our view not be possible for SOCs to merely comply with the PFMA without taking into account the more stringent requirements of the Companies Act.</p> <p>For SOC boards to consider:</p> <ul style="list-style-type: none"> • Are audit committee members sufficiently independent and skilled in order to perform their duties effectively and independently?
Responsibilities of the audit committee			
<p>Section 94 (7) spells out the responsibilities:</p> <ul style="list-style-type: none"> • To nominate the external auditor (see below); • To determine auditor fees and terms of engagement (see below); 	<p>In terms of Treasury Regulation 27.1.6-13, the audit committee must operate in terms of written terms of reference, which must deal adequately with its membership, authority and responsibilities. The terms of reference must be reviewed at least annually to ensure their relevance.</p>	<p>Principles 4-10 cover the audit committee's responsibilities, which are to:</p> <ul style="list-style-type: none"> • Oversee integrated reporting, which consists of an integrated financial and sustainability report (3.4); • Ensure that a combined assurance model is applied (3.5); 	<p>The Companies Act, PFMA and King III all contain detailed duties of the audit committee. There are in our view no conflicts. It is rather a question of merging the different duties in an audit committee's terms of reference.</p> <p>The one additional requirement in King III is the involvement of the audit committee in sustainability reporting</p>

Companies Act	PFMA	King III	Comment
Responsibilities of the audit committee			
<ul style="list-style-type: none"> To ensure that the appointment of the auditor complies with the provisions of the Companies Act and any other legislation (see below); To determine the nature and extent of any non-audit services and pre-approve any proposed agreement for the provision of non-audit services (see below); To prepare a report, to be included in the annual financial statements for that financial year (see below); To receive and deal appropriately with any concerns or complaints, whether from within or outside the SOC, or on its own initiative, relating to: 	<p>It must be disclosed in the SOC's annual report whether or not the audit committee has adopted formal terms of reference and if so, whether the committee satisfied its responsibilities for the year, in compliance with these terms of reference.</p> <p>The responsibilities must, at a minimum, include a review of:</p> <ul style="list-style-type: none"> The effectiveness of the internal control systems and internal audit; The risk areas to be covered in the scope of internal and external audits; The adequacy, reliability and accuracy of financial information; Any accounting and auditing concerns identified as a result of internal and external audits; The SOC's compliance with legal and regulatory provisions; The activities of the internal audit function, and The independence and objectivity of the external auditors. <ul style="list-style-type: none"> i. The accounting practices and internal audit of the SOC; ii. The content or auditing of the SOC's financial statements; iii. The internal financial controls of the SOC; or iv. Any related matter; 	<ul style="list-style-type: none"> Satisfy itself of the expertise, resource and experience of the SOC's finance function (3.6); Oversee internal audit (3.7); Be an integral component of risk management (3.8); Appoint the external auditor and oversee the process (3.9); Report to the board and shareholders on how it discharged its duties (3.10). 	<p>For SOC boards to consider:</p> <ul style="list-style-type: none"> Do the duties of the audit committee as set out in the terms of reference cover all the duties referred to in the Companies Act and the PFMA? Does the board understand how to integrate sustainability considerations when setting strategy? <p>Do the board and the audit committee understand their respective responsibilities with regard to sustainability reporting?</p>

Companies Act	PFMA	King III	Comment
Responsibilities of the audit committee			
<ul style="list-style-type: none"> To make submissions to the board on any matter concerning the SOC's accounting policies, financial control, records and reporting; and 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 SOC <p>Section 94(10) states that neither the appointment nor the duties of an audit committee reduce the functions and duties of the board of the SOC, except with respect to the appointment, fees and terms of engagement of the auditor.</p>	<p>The audit committee must have explicit authority to investigate matters within its powers and be provided with the necessary resources it needs to investigate such matters and shall have full access to information.</p> <p>The audit committee's reporting responsibilities as a minimum are:</p> <ul style="list-style-type: none"> To report and make recommendations to the board; To report on the effectiveness of internal controls in the annual report of the institution; and To comment on its evaluation of the financial statements in the annual report. <p>The audit committee must communicate any concerns it deems necessary to the Minister, the Auditor-General and if appropriate, to the external auditor.</p> <p>The audit committee must meet at least annually with the Auditor-General or the external auditor, whichever is applicable, to ensure that there are no unresolved issues of concern.</p>		
Audit committees and internal controls			
<p>Section 94(7) determines that the audit committee must report on the internal controls of the SOC as part of its report to be included in the annual financial statements of the SOC.</p> <p>The audit committee must also deal appropriately with any concerns or complaints relating to the internal financial controls of the SOC.</p>	<p>Treasury Regulation 27.1.8 deals with the duty of the audit committee to review the effectiveness of the internal control systems along with the effectiveness of internal audit and report thereon as part of its report in the annual report.</p>	<p>Under Principle 3.8 (The audit committee should be an integral component of the risk management process), it is recommended that internal audit should conduct a formal documented review of the design, effectiveness and implementation of the SOC's system of internal financial controls.</p>	<p>There is no contradiction between the PFMA, the Companies Act and King III concerning the duty of audit committees in relation to the system of internal controls. King III has the additional requirement that the audit committee should base its reporting on the effectiveness of the system of internal financial controls on a formal documented assessment by internal audit.</p>

Companies Act	PFMA	King III	Comment
Audit committees and internal controls			
		<p>The audit committee should evaluate the nature and extent of this review and conclude and report annually to the shareholders and the board on the effectiveness of the SOC's internal financial controls.</p> <p>Before the audit committee concludes and reports to the board on the effectiveness of internal financial controls, it should consider all information brought to its attention from all sources holistically, including communications with, and reports from, internal audit, other assurance providers and management, as well as the external auditors.</p> <p>King III also reflects the Companies Act requirement to deal with complaints regarding internal financial controls.</p>	<p>A higher governance requirement is therefore recommended in King III and an SOC should either apply the recommendation or explain why if it has not.</p> <p>For SOC boards to consider:</p> <ul style="list-style-type: none"> • Has the board and audit committee considered the benefits of a formal documented review of the system of internal financial control to be conducted once a year? • If such review will not be conducted, have both the board and audit committee satisfied themselves that sound judgement in the best interest of the SOC has been applied and that the reasons for the decision can be explained and justified?
External audit			
<p>Section 94(7)(a) deals with the responsibilities of the audit committee regarding external audit:</p> <p>The audit committee nominates for appointment as auditor a registered auditor who, in the opinion of the audit committee, is independent of the SOC and ensures that the appointment of the auditor complies with the provisions of the Companies Act and any other legislation relating to the appointment of auditors. In so doing, the audit committee must consider the rotation requirements set out in section 92, which states that the same individual may not serve as the auditor or designated auditor of an SOC for more than five consecutive financial years.</p>	<p>Treasury Regulation 27.1.8, requires the audit committee to review:</p> <ul style="list-style-type: none"> • The independence and objectivity of the external auditors; • Risk areas of the SOC to be covered by the external audit scope; and • Any accounting or auditing concerns identified by external audit. <p>Treasury Regulation 27.1.13 states that the audit committee must meet with the external auditor at least annually to ensure there are no unresolved issues.</p>	<p>Principle 3.9 highlights the need for the audit committee, as part of its recommendation concerning the appointment, reappointment and removal of auditors to shareholders, to assess the auditing firm and the individuals' qualifications, expertise and resources, effectiveness and independence.</p> <p>In terms of paragraph 76, the audit committee must approve the external auditor's terms of engagement and remuneration.</p>	<p>The PFMA contains less detail than the Companies Act and King III in relation to the audit committee's role concerning the appointment of the external auditor.</p> <p>The independence, objectivity and effectiveness of the external auditor seem to be the central concern of all these provisions.</p> <p>For SOC boards to consider:</p> <ul style="list-style-type: none"> • Are all the processes in place to ensure the independence of the auditor and the effectiveness of the audit process?

Companies Act	PFMA	King III	Comment
External audit			
<p>The audit committee should also determine the fees to be paid to the auditor and the auditor's terms of engagement.</p> <p>As part of the audit committee's report in the annual financial statements, it must state whether the audit committee is satisfied that the auditor was independent of the SOC.</p> <p>The evaluation of the independence of the registered auditor receives attention in section 94(8): The audit committee must ascertain that the auditor does not receive any direct or indirect remuneration or other benefit from the SOC, except—</p> <ul style="list-style-type: none"> i. As auditor; or ii. For rendering other services to the SOC, to the extent permitted and approved by the audit committee. <p>The audit committee should consider whether the auditor's independence may have been prejudiced, as a result of any previous appointment as auditor or having regard to the extent of any consultancy, advisory or other work undertaken by the auditor for the SOC.</p> <p>The audit committee should consider compliance with other criteria relating to independence or conflict of interest as prescribed by the Independent Regulatory Board for Auditors established by the Auditing Profession Act, 2005.</p>	<p>In terms of paragraph 77, the audit committee must review, monitor and report on the external auditor's independence and objectivity, and should assess the effectiveness of the audit process every year. At least every five years, rotation at an individual engagement partner or designated partner level enhances actual and perceived independence.</p> <p>Furthermore, paragraph 78 requires the audit committee to define a policy for board approval, addressing the nature, extent and terms under which the external auditor may perform non-audit services.</p> <p>In paragraph 81 it is recommended that the board should develop a process to ensure that the audit committee receives notice of reportable irregularities (as defined in the Auditing Profession Act, 2005) that have been reported by the external auditor to the Independent Regulatory Board for Auditors. Where the auditor's report is modified as a result of a reportable irregularity, the audit committee should review the completeness and accuracy of the disclosure of such matters in the financial statements.</p>		

Companies Act	PFMA	King III	Comment
Reporting by the audit committee			
<p>Section 94(7)(f) states that the audit committee must prepare a report, to be included in the annual financial statements for that financial year describing how the audit committee carried out its functions; stating whether the audit committee is satisfied that the auditor was independent of the SOC; and commenting in any way the committee considers appropriate</p>	<p>Treasury Regulation 27.1.7 requires the audit committee to disclose in the SOC's annual report whether or not the audit committee has adopted formal terms of reference and if so, whether the committee satisfied its responsibilities for the year, in compliance with its terms of reference.</p> <p>Treasury Regulation 27.1.10 stipulates that the audit committee must report and make recommendations to the board; report on the effectiveness of internal controls in the annual report of the institution; and comment on its evaluation of the financial statements in the annual report.</p>	<p>Principle 3.10 highlights the duty of the audit committee to report to the shareholders at the AGM on how it has discharged its duties in terms of the Companies Act, as well as those assigned by the board, during the financial year.</p> <p>This report must describe how the audit committee carried out its functions in terms of the Companies Act; state whether the audit committee is satisfied that the external auditor was independent of the SOC; and contain comment in any way the committee considers appropriate on the financial statements, the accounting practices and the internal financial control of the SOC.</p> <p>Paragraph 85 also requires the audit committee to provide the following information in the integrated report:</p> <ul style="list-style-type: none"> • A summary of the role of the audit committee; • A statement as to whether or not the audit committee has adopted a formal terms of reference that have been approved by the board and if so, whether the committee satisfied its responsibilities for the year in compliance with its terms of reference; • The names and qualifications of all members of the audit committee during the period under review, and the period for which they served on the committee; • The number of audit committee meetings held during the period under review and members' attendance at these meetings; 	<p>The reporting requirements for audit committees under King III are much more extensive than those contained in the Companies Act or the PFMA.</p> <p>King III makes it clear that the audit committee will have a dual reporting line in the case of most SOCs (unless the enabling legislation provides otherwise). There are certain statutory duties that must be reported to the shareholder in addition to other duties delegated to the audit committee by the board that should be reported to the board.</p> <p>We believe it will be most appropriate for the audit committee to report as recommended by King III as this represents the higher governance standard.</p> <p>For the SOC boards to consider:</p> <ul style="list-style-type: none"> • Will the duties to be performed by the audit committee, as set out in its terms of reference, enable the audit committee to report on all the matters required by King III?

Companies Act	PFMA	King III	Comment
Reporting by the audit committee			
		<ul style="list-style-type: none"> • A statement on whether or not the audit committee considered and recommended the internal audit charter for approval by the board; • A description of the working relationship with the chief audit executive; • Information about any other responsibilities assigned to the audit committee by the board; • A statement of whether the audit committee complied with its legal, regulatory or other responsibilities; and • A statement of whether the audit committee recommended the integrated report to the board for approval. 	



4. Conclusion

SOCs should strive to apply King III in conjunction with the regulatory provisions, even contradictory provisions, in order to achieve the overarching principles of sound governance, namely, responsibility, accountability, fairness and transparency in the interest of the substance rather than the mere form of sound governance.

By approaching compliance and governance with this view in mind, directors of SOC's will have a positive effect on SOC's and their stakeholders, including most importantly, the vested interests of the citizens of South Africa.



5. References

Companies Act, 2008 (Act No.71 of 2008)

Public Finance Management Act, 1999 (Act No. 1 of 1999) as amended by the Public Finance Management Amendment Act, 1999 (Act No. 29 of 1999)

Treasury Regulations to the PFMA, as contemplated in section 76 of the PFMA

Directive 5: Determining the GRAP reporting framework, Accounting Standards Board, 2009.

King Report on Governance for South Africa – 2009

King's Counsel – Understanding and unlocking the benefits of sound corporate governance (PricewaterhouseCoopers, 2009)

The membership of the Public Sector Working Group may be viewed at www.iodsa.co.za.

ⁱ Refer to the King Report on Governance in South Africa – 2009 for a definition of laws, rules, codes and standards

ⁱⁱ All companies are currently regulated by the Companies Act, No. 61 of 1973. This Act will be replaced by the (new) Companies Act. The Companies Act was promulgated by the President on 8 April 2009, but is currently undergoing amendments. The regulations to the Companies Act are also in draft. This Position Paper considers the Companies Act as at 8 April 2009.

