Business School
Corporate Governance Series

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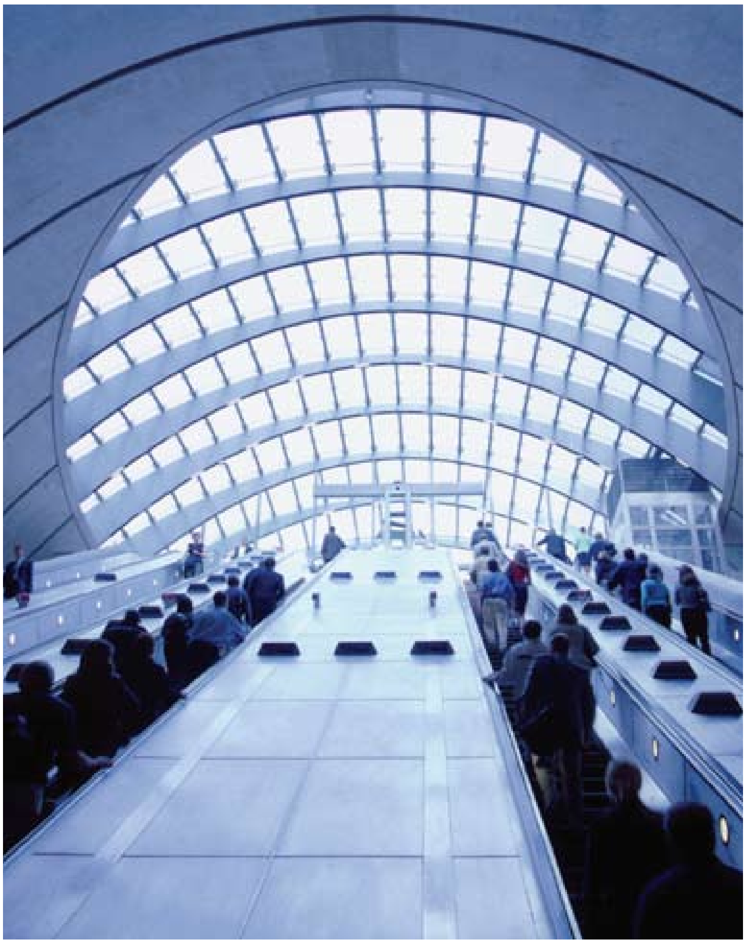
King's Counsel

Board Committees

Steering Point



Inside

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1. Introduction

The King Committee on governance issued the *King Report on Governance for South Africa – 2009* (the "Report") and the *King Code of Governance Principles – 2009* (the "Code"), together referred to as "King III", on 1 September 2009.

The issuance of King III was necessitated by the new Companies Act of South Africa[1] and the changes in international governance trends that have emerged since the release of the second King Report on Corporate Governance for South Africa (King II) in 2002.

King III dedicates an entire chapter to boards and directors and highlights the pivotal role directors and committees of the board play in achieving good governance. This publication discusses selected aspects related to the practical functioning of board committees. It also discusses committees recommended by the Companies Act, 2008 and King III.

It is important to note that not all companies will be required to have all of the committees described here. Companies must develop a corporate governance structure that best suits their needs. Some companies may consider it appropriate for the role of the risk committee to be incorporated into, for example, the audit committee or for the function to be performed by the board itself.

2. The role of board committees

In order to understand the role of board committees, it is important to understand the role of the board as a whole. The board is responsible for the strategic direction, governance and effective control of the company. King III states that "The board's paramount responsibility is the positive performance of the company in creating value. In doing so, it should appropriately consider the legitimate interests and expectations of all its stakeholders."

In discharging the responsibilities described above, the board may make an assessment that certain functions are better performed by committees rather than by the board itself. In performing these functions on behalf of the board, committees need to be guided by clearly defined terms of reference that succinctly set out the composition of the committee; its objectives, purpose and functions; what authority has been delegated to it; its tenure; and the manner in which it will report to the board. The terms of reference of board committees should also be disclosed in the integrated report.

In order to maintain the relevance of board committees, King III recommends that their terms of reference be reviewed every year, with changes approved by the board.

3. Composition and membership of board committees

Board committee members will usually be selected from the board of directors. Since a board should be comprised of a number of directors with a diversity of skills, committees should be carefully constituted from those directors that have the skills appropriate to the needs and objectives of the committee.

Another important consideration is the composition of board committees as it pertains to executive and non-executive directors. King III recommends that board committees should be chaired by independent non-executive directors and that the majority of committee members be non-executive directors. In instances where the committee is governed by legislation, for example the audit committee, it is important to understand that the legislative requirements relating to the composition may affect the balance of the committee. Therefore the audit committee, which is governed by the Companies Act, must consist only of non-executive directors.

Where a board committee does not have the appropriate skills to adequately deal with the subject matter at hand, persons with the necessary relevant expertise will usually be invited to attend committee meetings in order to provide the technical expertise required. It is important to note that these persons act in the capacity of consultants to the committee in these instances. They would not usually be part of the decision-making process and would therefore not vote on matters.

King III highlights that "Non-directors serving as members on committees of the board should be aware of section 76 of the Act which places the same standards of conduct and liability on such individuals as if they were directors". King III therefore recommends that these experts should attend as independent contractors and not as members of the committee.

The integrated report should include disclosure about the composition of board committees and external advisers who regularly attend or are invited to attend committee meetings.

4. The audit committee

The audit committee is one of those committees that King III specifically mentions. However, the concept of an audit committee is not a new one since it exists both in King II and is required by the Companies Act, 1973 for certain companies. However, the additional responsibilities imposed on the committee by King III and the Companies Act, 2008 highlight the importance of the committee from a corporate governance perspective.

[1] The Companies Act, 2008 constitutes the redraft of the Companies Act, 1973. It was assented to and signed by the President on 8 April 2009. The Act will come into operation on a date which is yet to be determined by the President.

These responsibilities are defined both in the Companies Act and in King III and include a wide array of responsibilities that span aspects of integrated reporting; financial statements and related matters; sustainability reporting; interim and summarised information and reports; combined assurance; and internal and external assurance providers.

It is important to note, as stated in King III, that "The Act has transformed the audit committee of listed companies and state owned companies from being a committee of the board to a separate statutory committee that is appointed by the shareholders. However, as indicated by Section 94(10) of the Act, the audit committee still forms part of a unitary board even though it has specific statutory responsibilities over and above responsibilities assigned to it by the board".

These specific statutory responsibilities relate to the requirement for the audit committee to include a written statement in the integrated report. The statement covers many issues, ranging from whether the committee considered the external auditor to be independent, to its role in oversight over the integrated report. An area where King III has generated a significant amount of discussion has been the requirement for a statement by the audit committee regarding the internal financial controls of the company. King III requires the audit committee to conclude and report yearly to the stakeholders and the board on the effectiveness of the company's internal financial controls.

Another key change to the scope of the audit committee's responsibility under King III relates to its new responsibility for sustainability reporting. Whilst it is clear that the responsibility for the integrated report and sustainability reporting rest ultimately with the board, King III recommends that the audit committee assist the board in reviewing sustainability reporting to ensure that the information is reliable and that no conflicts or differences arise when compared to the financial results. The audit committee is in the best position to make this assessment given its close involvement with the financial results.

The audit committee is also expected to apply its mind in considering and recommending to the board whether or not to engage an external assurance provider to provide assurance over the accuracy and completeness of material elements of sustainability reporting. The responsibilities of the audit committee will be discussed further in future editions of *Steering Point.*

The composition and membership of the audit committee is also addressed in King III. Whereas King II recommended that the majority of members should be independent non-executive directors, King III recommends that all members should be independent non executive directors. King III also recommends that the audit committee consist of at least three members and that the committee meet as frequently as possible, but at least twice a year.

The qualifications of audit committee members and their required skills are also discussed for the first time in King III. These are, however, directed at the audit committee as a whole and are addressed in the table in annexure A.

5. The risk committee

"The risk committee or audit committee should assist the board in carrying out its risk responsibilities"
– King III

King III specifically recommends that the risk committee be constituted by the board as a good governance practice. It recommends that the committee meet at least twice a year. The responsibilities of the committee include the review of "the risk management progress and maturity of the company, the effectiveness of risk management activities, the key risks facing the company, and the responses to address these key risks."

In many companies this committee has been combined with the audit committee to form an audit and risk committee. In practice, many have noted that the work effort expected of committee members in performing their duties in relation to the audit committee means that very little time is left to address risk related matters. King III recognises this by stating that the responsibilities of the risk committee may be assigned to the audit committee only after "careful consideration to the resources available to the audit committee to adequately deal with risk governance in addition to its audit responsibilities".

In discussing the membership of the risk committee, King III recommends that "membership of the risk committee should include executive and non-executive directors". As discussed earlier, and particularly in the case of risk management activities, the involvement of members of senior management responsible for the various areas of risk management is important in order to obtain a holistic understanding of the risk management processes within the organisation. These individuals should therefore attend meetings by invitation.

Given the importance of IT in the modern business environment and the potential risk that it may expose the entity to, King III recommends that IT risks also be addressed by the risk committee. The responsibility extends to ensuring that these risks are addressed through appropriate governance processes.

6. The remuneration committee

King III specifically recommends that the remuneration committee be constituted by the board as a good governance practice. Given the recent scrutiny of executive pay by analysts and investors, the role of the remuneration committee has been given increased prominence.

This is reflected in King III, which discusses remuneration policies and practices in detail for the first time. Whilst the board ultimately remains responsible for setting and administrating remuneration, the remuneration committee should assist the board in discharging this responsibility in the long-term interests of the company. In performing this task, King III recommends that the remuneration committee perform "Risk-based monitoring of bonus pools and long-term incentives… to ensure that remuneration policies do not encourage behaviour contrary to the company's risk management strategy".

The remuneration committee should design a policy which helps it to determine appropriate remuneration levels. This policy would usually consider the mix between fixed and variable pay, base salary and bonuses, as well as the mix between long-term and short-term incentives. However, King III also requires the remuneration committee to "satisfy itself as to the accuracy of recorded performance measures that govern vesting of incentives".

An important part of the remuneration of staff and directors is their performance over the preceding period. King III envisages that board and director evaluations include an assessment of the "performance of the CEO and other executive directors, both as directors and as executives. The results of such an evaluation should also be considered by the remuneration committee to guide it in determining the remuneration of the CEO and other executive directors".

7. The nomination committee

King III specifically recommends that the nomination committee be constituted by the board as a good governance practice. The nomination committee is responsible for recommending directors to the board with a view to ensuring that the board has the appropriate skills and experience and represents an appropriate diversity of views and backgrounds. In carrying out its functions, the committee must ensure that proceedings are handled in a transparent manner. This responsibility of the committee extends to both new directors and directors available for re-election.

In assessing new directors, the committee should asses whether the basic requirements for directorship in the Companies Act are met, in that the proposed director has not, for example, been declared delinquent or is serving probation. The responsibility also involves reviewing background checks performed on the individual.

In assessing the re-election of current directors, King III recommends that the nomination committee consider the past performance of the director, his or her contribution to the entity and the objectivity of business judgement calls made by the director.

In light of the requirements of the Companies Act for the audit committees of certain companies to be appointed by shareholders at the AGM, the nomination committee may be tasked with proposing board members who fulfil the criteria for eligibility for audit committee membership to shareholders. King III also states that "The nomination committee and the board should evaluate whether collectively (but not necessarily individually) the audit committee has the necessary skills to perform its functions and responsibilities".

Lastly, the nomination committee should also be involved in the evaluation of directors and should review the evaluation procedures and results.

8. The sustainability committee

Where companies establish sustainability committees, these usually have a very narrowly defined focus that is incorporated into their terms of reference. They are often involved in much of the technical detail relating to the sustainability performance and reporting of the entity.

The committee usually acts as an advisory body to other committees, be it the risk or audit committees and is usually constituted both of directors and non directors. It may in many instances include specialists. King III recommends that even where a sustainability committee has been established, that the audit committee still take an active role with regard to sustainability performance and reporting. It is important to understand that the sustainability committee will, in most instances, be operationally and technically focused while the audit committee's responsibilities will relate more to the manner in which the sustainability information is presented and reported.

9. Group boards

"A governance framework should be agreed between the group and its subsidiary boards" – King III

The responsibilities of directors of holding companies that sit on subsidiary company boards have long been under discussion. It is clear that the directors of subsidiary companies have fiduciary duties in relation to the subsidiary and are required to act in the best interests of the subsidiary at all times, regardless of who appointed the director to the subsidiary board. King III elaborates that "In the case of a conflict between the duties of a nominee director to a company on whose board he sits and the interests of his principal, the duties of the director to the company of which he is a director must prevail".

It is for these reasons that a governance framework must be agreed between the group and its subsidiaries' boards. Developing such a framework, which includes matters such as the manner in which the holding company nominates directors to subsidiary boards, will result in good governance both across the group and in the underlying subsidiaries.

10. Assessing the performance of committees

Performance evaluations of board committees are an essential tool in determining whether the respective committees have the appropriate blend of skills and experience and whether they are functioning as envisaged in their terms of reference. Evaluations should be performed for individual members as well as for the committee as a whole. These evaluations may be led by the chairman, through the nominations committee or may be performed by an external party. To the extent that areas for improvement are identified, these should be addressed with the individual directors, or the chairman of the committee where the suggested improvements relate to the committee as a whole.

11. Annexure A

11.1 Boards and directors – Comparison with King II

	King III	King II
Board structure	Similar to King II.	Unitary board structure with executive directors and non-executive directors interacting in a working group
Composition of the board	The board should comprise a balance of power, with a majority of non-executive directors. The majority of non-executive directors should be independent.	The board should comprise a balance of executive and non-executive directors, **preferably** with a majority of non-executive directors of whom **sufficient** should be independent of management.
Executive director	Similar to King II.	An individual who is involved in the day-to-day management and/or is in the full time salaried employment of the company and/or any of its subsidiaries.
Non-executive director	Similar to King II.	An individual not involved in the day-to-day management and not a full-time salaried employee of the company or of its subsidiaries. An individual in the full-time employment of the holding company or its subsidiaries, other than the company concerned, would also be considered to be a non-executive director unless such individual by his/her conduct or executive authority could be construed to be directing the day-to-day management of the company and its subsidiaries.

	King III	King II
Independent non-executive director	A non-executive director who: i. Is not a representative of a shareholder who has the ability to control or significantly influence management or the board; ii. Has not been employed by the company or the group of which it currently forms part in any executive capacity, or appointed as the designated auditor or partner in the groups external audit firm, or senior legal advisor for the preceding three financial years; iii. Similar to (iii) in King II; iv. Similar to (iv) in King II; v. Is free from any business or other relationship which could be seen by an objective outsider to **interfere materially** with the individual's capacity to act in an independent manner, such as being a director of a material customer or supplier to the company. vi. Does not have a direct or indirect interest in the company (including any parent or subsidiary in a consolidated group with the company) which is either material to the director or to the company. A holding of five percent or more is considered material; and vii. Does not receive remuneration contingent upon the performance of the company.	A non-executive director who: i. Is not a representative of a **shareowner** who has the ability to control or significantly influence management; ii. Has not been employed by the company or the group of which it currently forms part, in any executive capacity for the preceding three financial years; iii. Is not a member of the immediate family of an individual who is, or has been in any of the past three financial years, employed by the company or the group in an executive capacity; iv. Is not a professional advisor to the company or the group other than in a director capacity; v. Is free from any business or other relationship which could be seen to **materially interfere** with the individual's capacity to act in an independent manner; vi. Is not a significant supplier to, or customer of the company or group; and vii. Has no significant contractual relationship with the company or group.

	King III	King II
Minimum number of executive directors on the board	As a minimum, two executive directors should be appointed to the board, being the chief executive officer and the director responsible for the finance function. For listed companies, a financial director must be appointed to the board from June 2009.	Not addressed.
Frequency of board meetings	Similar to King II.	The board should meet regularly, at least once a quarter if not more frequently as circumstances require.
Rotation of non-executive directors	A programme ensuring staggered rotation of non-executive directors should be put in place. Rotation of board members should be structured so as to retain valuable skills, to have continuity of knowledge and experience and to introduce persons with new ideas and expertise. At least one third of non-executive directors should retire by rotation at the company's AGM or other general meetings. The retiring board members may be re-elected, provided they are eligible.	Rotation of non-executive directors not addressed specifically. Regarding rotation of directors in general: There should be an effective programme of continuing rotation of appointments in respect of each individual director. All companies should adopt a process of staggered continuity and re-election of their boards to ensure continuity of experience and knowledge.
Removal of CEO	The memorandum of incorporation of the company should allow the board to remove any director from the board, including executive directors, without shareholder approval being necessary.	Not addressed.
Chairman of the board	The chairman of the board **should be** an independent non-executive director. The chairman of the board **should not be** the CEO.	The chairperson should **preferably be** an independent non-executive director. It is **preferable** that the chairperson and the CEO functions are kept separate.
Lead independent non-executive director	Should be appointed if the chairman of the board is not independent and free of conflicts of interest on appointment.	Consideration should be given to appointing a senior independent or "lead" director to fulfil a role where any difficulties or conflicts arise between the non-executive component of the board and the executives, as well as in assisting the chairperson in fulfilling his tasks where required. Such an appointment should be considered where the roles of the chairperson and the CEO are combined, or even where both the chairperson and deputy chairperson might be executive directors.

	King III	King II
Share options for non-executive directors	Non-executive directors **should not** receive share options.	Share options **may be** granted to non-executive directors but must be the subject of prior approval of shareowners.
Board committees	Unless legislated otherwise, the board should appoint the audit, risk, remuneration and nomination committees as standing committees. Smaller companies need not establish formal committees to perform these functions but should ensure that these functions are appropriately addressed by the board.	All companies should have, as a minimum, audit and remuneration committees.

11.2 Chairman of the board and CEO – membership on board committees

Summary of King III requirements:

	Member of the audit committee	Member of the remuneration committee	Chairman of the remuneration committee	Member of the nomination committee	Chairman of the nomination committee	Member of the risk committee	Chairman of the risk committee
Chairman of the board	No[9]	Yes[1]	No	Yes[2]	Yes[3]	Yes[4]	No
Chief Executive Officer	No[5]	No[6]	No	No[7]	No	Yes[8]	No

11.3 Board committees

Board committees should only comprise members of the board. External parties may be present at committee meetings by invitation.

The respective committees' chairmen should give at least an oral summary of their committee's deliberations at the board meeting following the committee meeting.

	Audit committee	Remuneration committee	Nomination committee	Risk committee
Chairman	Independent non-executive director	Independent non-executive director	Independent non-executive director	Not specified in King III
Membership	All members must be board members All members should be independent non-executive directors	All members must be board members Majority should be non-executive directors Majority of non-executive directors should be independent	All members must be board members Majority should be non-executive directors Majority of non-executive directors should be independent Board chairman to be a member	All members must be board members Executive and non-executive directors

1 The chairman of the board may be a member of the remuneration committee
2 The chairman of the board should be a member of the nomination committee
3 The chairman of the board may chair the nomination committee
4 The chairman of the board may be a member of the risk committee
5 The CEO should attend by invitation
6 The CEO should attend by invitation
7 The CEO should attend by invitation
8 King III does not prohibit the CEO from being a member of the risk committee
9 The chairman of the board may attend audit committee meetings by invitation

11.4 Audit committees – Comparison with King II

	King III	King II
Membership	All members should be independent non-executive directors. Audit committees at subsidiary level that will act as a subcommittee of the holding company may appoint executive directors within the group as audit committee members provided the directors are non-executive in relation to the specific subsidiary.	Majority of the members should be independent non-executive directors. Audit committees at subsidiary level not addressed.
Minimum number of members	Audit committees should consist of at least three members.	Not addressed.
Qualifications	The audit committee as a whole should have a good understanding of: • integrated reporting, including financial reporting, and sustainability issues • internal financial controls • internal and external audit processes • corporate law and risk management • IT governance as it relates to integrated reporting • the governance processes within the company.	Majority of members should be financially literate.
Frequency of meetings	As frequently as is necessary, but at least twice a year.	Not addressed.
Responsibility regarding sustainability reporting	The board may assign the overseeing of sustainability issues in the integrated report to the audit committee. The audit committee should assist the board in reviewing the sustainability reporting to ensure that the information is reliable and that no conflicts or differences arise when compared with the financial results. The audit committee should consider and recommend to the board the need to engage an external assurance provider to provide assurance over the accuracy and completeness of sustainability reporting.	Not addressed.

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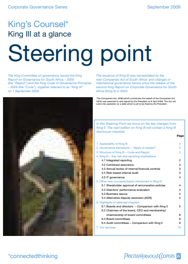
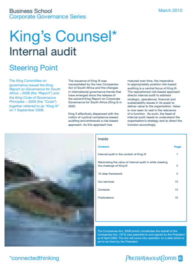


King III and related legislative requirements

Internal audit



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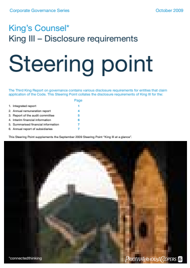
King III – Disclosure requirements



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