

# ***State-owned companies: The new Companies Act, PFMA and King III in perspective***

*A guide to balancing  
legislative requirements with  
sound corporate governance  
practices in state-owned  
companies*

*August 2012*

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## ***Steering Point*** Companies Act Series No: 4



## Overview

The new Companies Act, the (PFMA) and (King III) are all applicable to state-owned companies. They share many principles of good governance, and alignment of these is not only possible, but desirable in the spirit of the overarching governance principles of accountability, fairness, transparency and responsibility.

Despite the many commonalities, however, there are areas in which provisions and recommendations may contradict. When attempting to resolve areas of conflicts between the Companies Act and the PFMA, the PFMA prevails only where there are irreconcilable differences.

If, for instance, the Companies Act demands a more onerous requirement in one instance, then compliance with the Companies Act is necessary.

Reconciling the law (which must be adhered to) with governance recommendations (to be applied voluntarily) poses a challenge when there are incompatible contradictions.

We believe that in these instances (SOC) boards should play an active role in advocating changes to bring about amendments to align enabling legislation with sound governance principles.

Until such changes are effected, SOC boards should attempt to work within legislative constraints to bring about a sound governance outcome.

## Issues highlighted in this publication

- Practice recommendations made in King III set a new benchmark for directors' standards 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 standards.
- 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 within the wider framework of King III.
- Although there is inconsistency between the PFMA and the Companies Act regarding who elects the audit committee, this 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 highest governance standard.

## A note on terminology

For the purposes of this publication:

- The third *King Report on Governance for South Africa 2009* is referred to as 'the King Report'.
- The third *King Code of Governance Principles for South Africa 2009*, in which the principle provisions of the King Report are enshrined, is referred to as 'the King Code'.
- The King Report and the King Code are collectively referred to as 'King III'.
- The Companies Act or the Act refers to the Companies Act, No. 71 of 2008 as amended by the Companies Amendment Act, 2011; read with the Companies Regulations, 2011.
- The Regulations refers to the regulations to the Companies Act, No.71 of 2008.
- The PFMA refers to Public Finance Management Act, No. 1 of 1999.
- The MFMA refers to the Local Government: Municipal Finance Management Act, No. 56 of 2003.
- The Treasury Regulations refers to the regulations to the PFMA.
- 'Enabling' legislation refers to the legislation that provides for the establishment, control, functions, power and funding of a state-owned company.
- The abbreviation 'SOC' refers to state-owned company.

- Although not required by applicable legislation, an SOC board should give consideration 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 legislation. SOC audit committees should aspire to attain those higher reporting requirements.

## Governance, laws, ethics and compliance

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 a responsibility to consider adherence to codes and standards<sup>1</sup>. 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.

<sup>1</sup> Refer to the *King Report on Governance in South Africa – 2009* for a definition of laws, rules, codes and standards

## Introduction

This publication focuses on key laws, rules, codes and standards that concern the governance of an SOC. Its objective is to highlight those areas in which governance and legislation intersect and to offer a position on how varying and sometimes conflicting provisions can be reconciled. This is achieved by presenting a comparative analysis of various provisions that deal with governance contained in the Companies Act, the PFMA and King III.

## Definition of a state-owned company

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 principal 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 established the term ‘state-owned company’, which is defined in Section 1 as:

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

- a. is listed as a public entity in Schedule 2 or 3 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.

## Applicability of King III

King III applies to all entities regardless of the manner and form of incorporation or establishment, including state-owned entities. Principles are drafted on the basis that, if they are adhered to, any entity would have practiced good governance. It is recommended that all entities disclose which principles and/or practices they have decided not to apply or explain. This level of disclosure will allow stakeholders to comment on and challenge the board to improve the level of governance within an organisation.

## Governance framework

King III has adopted an ‘apply or explain’ governance framework. Where the board believes it to be in the best interests of the company, it can adopt a practice different from that recommended in King III, but must explain it. Explaining the different practice adopted and an acceptable reason for it, results in consistency with King III principles.

The framework recommended by King III is principles-based and there is no ‘one size fits all’ solution. Entities are encouraged to tailor the principles as appropriate to the size, nature and complexity of their organisation.

## Scope of this publication

In order to limit the range of variances in the PFMA provisions to be used in this comparative analysis, SOC not listed in schedule 2, 3B and 3D of the PFMA are not considered in this publication, 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 publication.

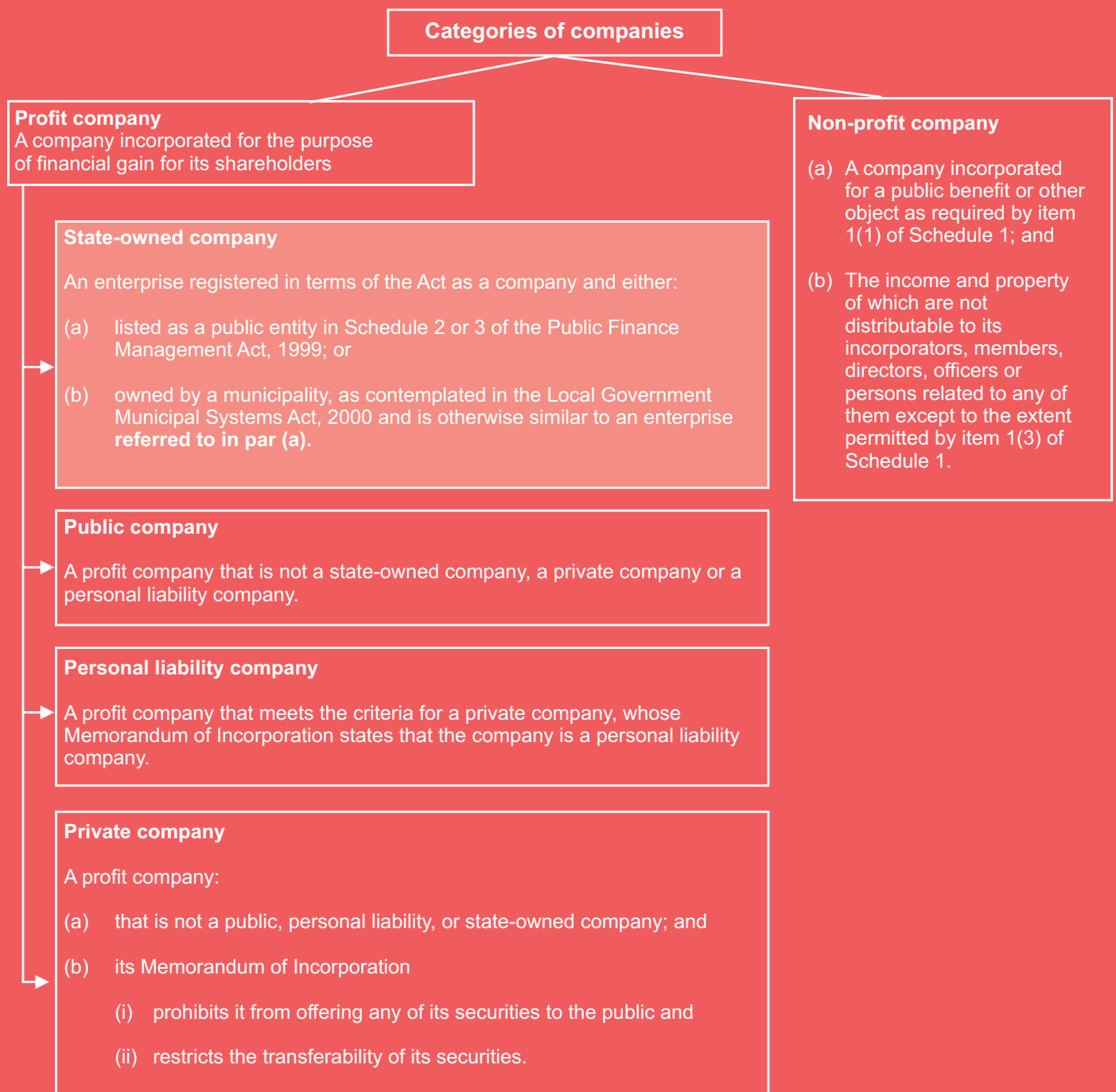
The release of King III in 2009 brought with it significant opportunities for SOC to adopt practices of good governance that correlate with the requirements of the Companies Act and the PFMA.



## Categorisation of companies

The Companies Act distinguishes between two main categories of companies, namely profit and non-profit companies. This categorisation effectively does away with the concepts of 'widely held' and 'limited interest' companies introduced by the Corporate Laws Amendment Act, 2006.

Except to the extent of ministerial exemption, the provisions of the Companies Act applicable to a public company also apply to a state-owned company.



Governance universe

An SOC’s existence is ordinarily made possible by enabling legislation, which provides for its establishment, control, powers, function and funding. While enabling acts are entity-specific, they are only referred to in this publication 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 SOC’s. 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 publication.

The Companies Act applies to all companies, including SOC’s.

Section 3(3) of the PFMA determines that if any conflict exists between the PFMA and another act, the PFMA prevails. However, Section 5(4) of the Companies Act determines that:

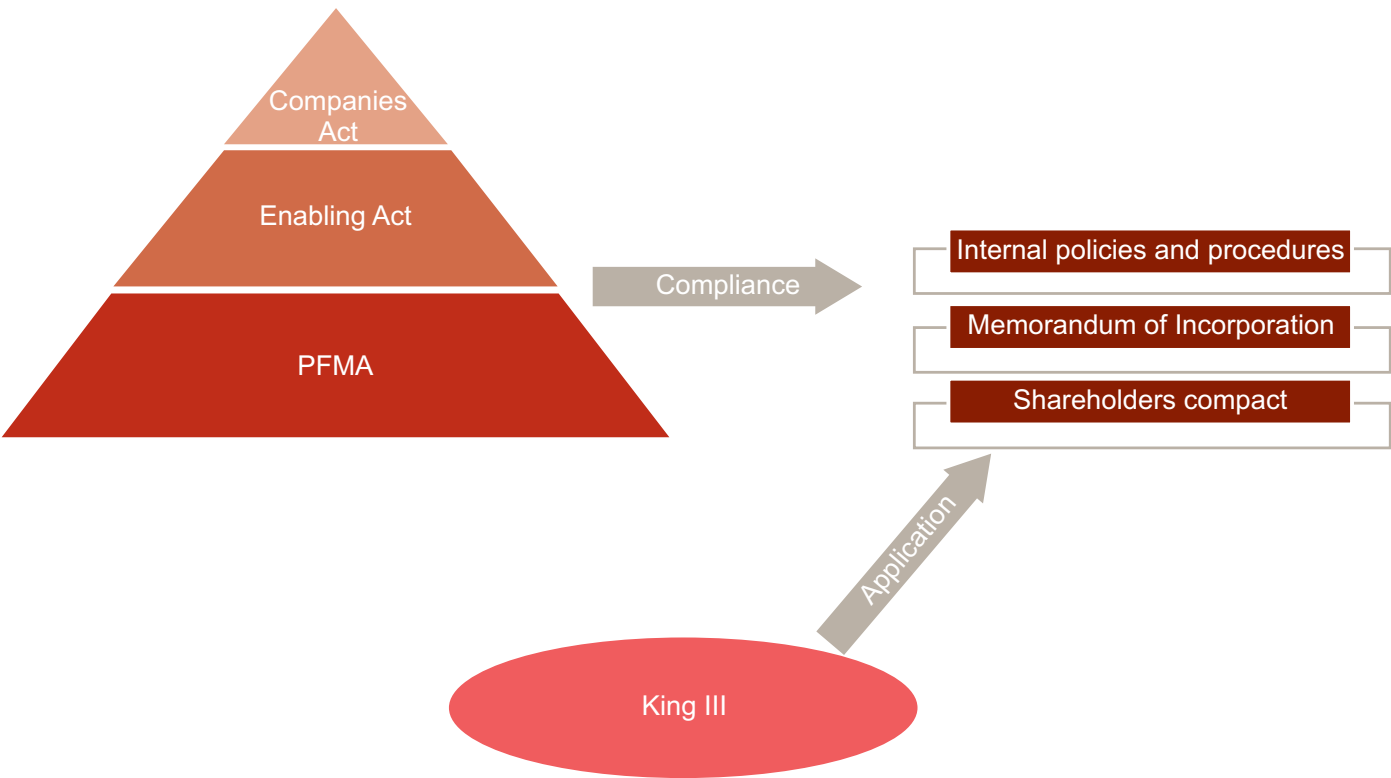
*If there is an inconsistency between any provision of this Act and a provision of any other national legislation–*

- a. the provisions of both Acts apply concurrently, to the extent that it is possible to apply and comply with one of the inconsistent provisions without contravening the second; and*
- b. to the extent that it is impossible to apply or comply with one of the inconsistent provisions without contravening the second–*
- i. Public Finance Management Act, 1999 (Act No. 1 of 1999);*

The interrelationship between the PFMA and the Companies Act can be seen in the similarity of their respective requirements for directors and the boards of SOC’s.

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 regulates matters in relation to companies that are wider in scope than simply financial management. These areas are discussed in the following section.

Effective, ethical leadership



## 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 SOC is provided to give some insight into the issues that need to be reconciled by SOC boards:

Companies Act	PFMA	King III	Comment
<b>Board accountability</b>			
<p>Section 66(1)<sup>2</sup> 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 72(4) read with Regulation 43 determines that the board of an SOC must establish a social and ethics committee.</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>Reference in King III to 'the board', is interpreted as equivalent to the accounting authority established in terms of the PFMA and enabling legislation in the SOC context.</p> <p>The Companies Act focusses on the authority of the board, whereas the focus of King III is on 'responsibility'.</p> <p>The significance of King III to the board, acting as the focal point of governance, is that boards of SOC should understand the specific responsibilities dealt with in the PFMA and Companies Act in terms of this governance principle.</p> <p><b>For SOC boards to consider:</b></p> <ul style="list-style-type: none"> <li>• Is there recognition that ultimate accountability for the SOC rests with the board?</li> <li>• Is there appreciation of the fact that a balance of power protects the board against the adverse consequences of a lack of checks and balances?</li> <li>• Has the SOC appointed a social and ethics committee with the requisite composition and which performs its functions as intended?</li> </ul>

<sup>2</sup> The term "company" has been replaced with the term "SOC" for purposes of this comparison.



Companies Act	PFMA	King III	Comment
<b>Standards of directors' conduct and conflicts of interest</b>			
<p>Section 76 sets out standards of directors' conduct in line with common law 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"> <li>• 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.</li> </ul> <p>The other duties of a director are to act:</p> <ul style="list-style-type: none"> <li>• In good faith and for proper purpose;</li> <li>• In the best interests of the SOC; and</li> <li>• 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.</li> </ul>	<p>Section 50 provides that the board of an SOC must:</p> <ul style="list-style-type: none"> <li>• Exercise the duty of utmost care to ensure reasonable protection of the assets and records of the SOC;</li> <li>• Act with fidelity, honesty, integrity and in the best interests of the SOC in managing the financial affairs of the SOC;</li> <li>• 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</li> <li>• Seek, within the sphere of influence of that board, to prevent any prejudice to the financial interests of the state.</li> </ul> <p>A director of the board may not:</p> <ul style="list-style-type: none"> <li>• Act in a way that is inconsistent with the responsibilities assigned to the board in terms of the PFMA; or</li> <li>• 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.</li> </ul> <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>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 of this principle deal with directors' conflicts of interest. They state 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>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.</p> <p>Duties outlined in the PFMA focus on financial management, whereas in the Companies Act, the emphasis is 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 detail to the overarching provisions of the Companies Act.</p> <p>The Companies Act provides for measures to determine whether directors have met the required standard of conduct. A number of phrases used in Section 76 highlight this: 'that may reasonably be expected of a person'; 'degree'; 'reasonably diligent steps'; and 'rational basis for believing'.</p> <p>The practices recommended in King III set the standard for directors' conduct and will be a measure for determining whether directors' conduct has met the standards described in the Companies Act.</p> <p>Directors should therefore understand that although King III contains voluntary practice recommendations, these could have far-reaching consequences in determining what reasonable conduct is for directors.</p> <div> <p><b>For SOC boards to consider:</b></p> <ul style="list-style-type: none"> <li>• The more established the governance practices recommended in King III become, the more likely a court will regard conduct that conforms to these practices as meeting the required standard of care.</li> <li>• Is there a conflict of interest policy in place that details conflict of interest procedures?</li> <li>• If so, is this policy evaluated to ascertain whether it achieves its objectives?</li> </ul> </div>



Companies Act	PFMA	King III	Comment
<p>The obligations of acting in the best interest of the SOC and of care, skill and diligence as contemplated in Subsection 3(b) and (c) are satisfied when a director:</p> <ul style="list-style-type: none"> <li>• Has taken reasonable diligent steps to become informed;</li> <li>• 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</li> <li>• 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.</li> </ul> <p>A director may rely on the information, recommendations, reports, etc. of the following persons:</p> <ul style="list-style-type: none"> <li>• Employees of the SOC that the director reasonably believes to be reliable and competent;</li> <li>• 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</li> <li>• 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.</li> </ul>			

Companies Act	PFMA	King III	Comment
<b>Role and functions of the board</b>			
<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"> <li>• Effective, efficient and transparent systems of financial and risk management and internal control;</li> <li>• 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;</li> <li>• An appropriate procurement and provisioning system, which is fair, equitable, transparent, competitive and cost effective; and</li> <li>• A system for properly evaluating all major capital projects prior to a final decision on the project.</li> </ul> <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 role and functions of the board are set out as follows:</p> <ul style="list-style-type: none"> <li>• Principle 2.1: The board should act as the focal point for and custodian of corporate governance;</li> <li>• Principle 2.2: The board should appreciate that strategy, risk, performance and sustainability are inseparable;</li> <li>• Principle 2.3: The board should provide effective leadership based on an ethical foundation;</li> <li>• Principle 2.4: The board should ensure that the SOC is and is seen to be a responsible corporate citizen;</li> <li>• Principle 2.5: The board should ensure that the SOC's ethics are managed effectively;</li> <li>• Principle 2.6: The board should ensure that the SOC has an effective and independent audit committee;</li> <li>• Principle 2.7: The board should be responsible for the governance of risk;</li> <li>• Principle 2.8: The board should be responsible for information technology (IT) governance;</li> <li>• Principle 2.9: The board should ensure that the SOC complies with applicable laws and considers adherence to non-binding rules, codes and standards;</li> <li>• Principle 2.10: The board should ensure that there is an effective risk-based internal audit;</li> <li>• Principle 2.11: The board should appreciate that stakeholders' perceptions affect the SOC's reputation;</li> <li>• Principle 2.12: The board should ensure the integrity of the SOC's integrated report;</li> <li>• Principle 2.13: The board should report on the effectiveness of the SOC's system of internal controls;</li> <li>• Principle 2.14: The board and its directors should act in the best interests of the SOC;</li> </ul>	<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 recommend that the boards of SOC's adopt this approach.</p> <p>As far as the appointment of the chairman of the board and the CEO are concerned, the enabling legislation often provides that the shareholder or executive authority makes these appointments. This contradicts the recommendations of King III.</p> <div> <p><b>For SOC boards to consider:</b></p> <ul style="list-style-type: none"> <li>• 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?</li> <li>• 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?</li> </ul> </div>

Companies Act	PFMA	King III	Comment
	<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> <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.</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"> <li>• 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;</li> <li>• 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</li> <li>• Principle 2.17: The board should appoint the CEO and establish a framework for the delegation of authority.</li> </ul>	
<b>Election of audit committees</b>			
Section 94(2) provides that the audit committee must be elected by the shareholders at the annual general meeting.	The board must establish an audit committee (Treasury Regulation 27.1.1), while audit committees may also be shared between an SOC and its subsidiaries.	Principle 3.1 determines that the board should ensure that the SOC has an effective and independent audit committee.	<p>The provisions of the Companies Act conflict with those of the PFMA regarding the election of the audit committee members. Section 3(3) of the PFMA determines that if any conflict exists between the PFMA and another Act, the PFMA prevails.</p> <p>However, 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 ensuring that the audit committee is effective.</p> <p>Similarly, if the board is responsible for electing the audit committee (by virtue of its enabling legislation), it needs to follow a process that will safeguard the independence of the audit committee.</p> <div> <p><b>For SOC boards to consider:</b></p> <ul style="list-style-type: none"> <li>• Is the board proactive in ensuring an effective and independent audit committee?</li> </ul> </div>

Companies Act	PFMA	King III	Comment
<b>Membership of the audit committee</b>			
<p>Membership requirements are stipulated in Section 94(4) and (5), but determine 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(4) specifies that each member of an audit committee must be a director of the SOC. Section 94(5) determines that members must satisfy 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.</p> <p>Such members, inter alia, 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 in terms of sub-section (7) .</p> <p>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 in terms of section (6).</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.</p> <p>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"> <li>• Integrated reporting, which includes financial reporting;</li> <li>• Internal financial controls;</li> <li>• External audit process;</li> <li>• Internal audit process;</li> <li>• Corporate law;</li> <li>• Risk management;</li> <li>• Sustainability issues;</li> <li>• Information technology governance as it relates to integrated reporting; and</li> <li>• The governance processes within the SOC.</li> </ul> <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 a higher governance standard.</p> <p>In our view, it will not be possible for SOCs to merely comply with the PFMA without taking into account the more stringent requirements of the Companies Act.</p> <div> <p><b>For SOC boards to consider:</b></p> <p>Are audit committee members sufficiently independent and skilled in order to perform their duties effectively and independently?</p> </div>



Companies Act	PFMA	King III	Comment
<b>Responsibilities of the audit committee</b>			
<p>Section 94 (7), inter alia, sets out the duties of the audit committee:</p> <ul style="list-style-type: none"> <li>• To nominate the external auditor (see below);</li> <li>• To determine auditor fees and terms of engagement (see below);</li> <li>• To ensure that the appointment of the auditor complies with the provisions of the Companies Act and any other legislation (see below);</li> <li>• 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);</li> <li>• To prepare a report, to be included in the annual financial statements for that financial year (see below);</li> <li>• To receive and deal appropriately with any concerns or complaints, whether from within or outside the SOC, or on its own initiative, relating to: <ul style="list-style-type: none"> <li>• The accounting practices and internal audit of the SOC;</li> <li>• The content or auditing of the SOC's financial statements;</li> <li>• The internal financial controls of the SOC; or</li> <li>• Any related matter;</li> </ul> </li> <li>• To make submissions to the board on any matter concerning the SOC's accounting policies, financial control, records and reporting; and</li> <li>• To perform other oversight functions determined by the board.</li> </ul> <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,</p>	<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>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> <p>The effectiveness of the internal control systems and internal audit;</p> <p>The risk areas to be covered in the scope of internal and external audits;</p> <p>The adequacy, reliability and accuracy of financial information;</p> <p>Any accounting and auditing concerns identified as a result of internal and external audits;</p> <p>The SOC's compliance with legal and regulatory provisions;</p> <p>The activities of the internal audit function, and</p> <p>The independence and objectivity of the external auditors.</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"> <li>• To report and make recommendations to the board;</li> </ul>	<p>Principles 4-10 cover the audit committee's responsibilities, which are to:</p> <ul style="list-style-type: none"> <li>• Oversee integrated reporting, which consists of an integrated financial and sustainability report (3.4);</li> <li>• Ensure that a combined assurance model is applied (3.5);</li> <li>• Satisfy itself of the expertise, resource and experience of the SOC's finance function (3.6);</li> <li>• Oversee internal audit (3.7);</li> <li>• Be an integral component of risk management (3.8);</li> <li>• Appoint the external auditor and oversee the process (3.9);</li> <li>• Report to the board and shareholders on how it discharged its duties (3.10).</li> </ul>	<p>The Companies Act, PFMA and King III all contain detailed duties of the audit committee.</p> <p>In our view there are no conflicts. It is rather a question of merging the different duties in an audit committee's terms of reference.</p> <p>An additional requirement in King III is for the involvement of the audit committee in sustainability reporting.</p> <p><b>For SOC boards to consider:</b></p> <ul style="list-style-type: none"> <li>• 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?</li> <li>• Does the board understand how to integrate sustainability considerations when setting strategy?</li> <li>• Do the board and the audit committee understand respective responsibilities with regard to sustainability reporting?</li> </ul>

Companies Act	PFMA	King III	Comment
except with respect to the appointment, fees and terms of engagement of the auditor.	<ul style="list-style-type: none"> <li>To report on the effectiveness of internal controls in the annual report of the institution; and</li> <li>To comment on its evaluation of the financial statements in the annual report.</li> </ul> <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>		
<b>Audit committees and internal controls</b>			
<p>Section 94(7) determines that the audit committee must report on the internal financial 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>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>There is no contradiction between the PFMA, the Companies Act and King III concerning the duty of audit committees in relation to the internal system of internal financial controls.</p> <p>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> <p>A higher governance requirement is therefore recommended in King III and a SOC should either apply the recommendation or explain why it has not.</p> <div> <p><b>For SOC boards to consider:</b></p> <ul style="list-style-type: none"> <li>Have 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?</li> <li>If such a review will not be conducted, have both the board and audit committee satisfied themselves that sound judgement in the best interests of the SOC has been applied and that the reasons for the decision can be explained and justified?</li> </ul> </div>

Companies Act	PFMA	King III	Comment
<b>External audit</b>			
<p>Section 94(7)(a) and 94(8) deals with the responsibilities of the audit committee regarding external audit.</p> <p>The audit committee must nominate for appointment as auditor a registered auditor who, in the opinion of the audit committee, is independent of the SOC and must ensure that the appointment of the auditor complies with the provisions of the Companies Act and any other legislation relating to the appointment of auditors.</p> <p>In so doing, the audit committee must consider the rotation requirements set out in Section 92, which state 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>The audit committee should also determine the fees to be paid to the auditor and the auditor's terms of engagement, in terms of Section 94(7)(b).</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, in terms of (Section 94(f)(b)(ii)).</p> <p>The evaluation of the independence of the registered auditor receives attention in Section 94(8), which states that 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"> <li>• As auditor; or</li> <li>• For rendering other services to the SOC, to the extent permitted and approved by the audit committee.</li> </ul>	<p>Treasury Regulation 27.1.8 requires the audit committee to review:</p> <ul style="list-style-type: none"> <li>• The independence and objectivity of the external auditors;</li> <li>• Risk areas of the SOC to be covered by the external audit scope; and</li> <li>• Any accounting or auditing concerns identified by external audit.</li> </ul> <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>In terms of paragraph 77, the audit committee must review, monitor and report on the external auditor's independence and objectivity. It should also assess the effectiveness of the audit process every year.</p> <p>At least every five years, rotation at an individual engagement partner or designated partner level enhances actual and perceived independence.</p> <p>Paragraph 78 requires the audit committee to define a policy 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 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.</p> <p>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>	<p>The PFMA is less detailed than the Companies Act and King III in relation to the audit committee's role in the appointment of the external auditor.</p> <p>The independence, objectivity and effectiveness of the external auditor seem to be the central focus of all these provisions.</p> <p><b>For SOC boards to consider:</b></p> <ul style="list-style-type: none"> <li>• Are all the processes in place to ensure the independence of the auditor and the effectiveness of the audit process?</li> </ul>

Companies Act	PFMA	King III	Comment
<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 conflicts of interest as prescribed by the Independent Regulatory Board for Auditors established by the Auditing Profession Act, 2005.</p>			
<b>Reporting by the audit committee</b>			
<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:</p> <ul style="list-style-type: none"> <li>• Describing how the audit committee carried out its functions;</li> <li>• Stating whether the audit committee is satisfied that the auditor was independent of the SOC; and</li> <li>• Commenting in any way the committee considers appropriate on the financial statements, accounting practices and internal financial control.</li> </ul>	<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 provide 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 annual financial statements:</p> <ul style="list-style-type: none"> <li>• A summary of the role of the audit committee;</li> <li>• 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;</li> </ul>	<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 has a dual reporting line in the case of most SOCs (unless the enabling legislation provides otherwise).</p> <p>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 is appropriate for the audit committee to report as recommended by King III, as this represents the higher governance standard.</p> <p><b>For SOC boards to consider:</b></p> <ul style="list-style-type: none"> <li>• 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?</li> </ul>



Companies Act	PFMA	King III	Comment
	.	<ul style="list-style-type: none"> <li>• 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;</li> <li>• The number of audit committee meetings held during the period under review and members' attendance at these meetings;</li> <li>• A statement as to whether or not the audit committee considered and recommended the internal audit charter for approval by the board;</li> <li>• A description of the working relationship with the chief audit executive;</li> <li>• Information about any other responsibilities assigned to the audit committee by the board;</li> <li>• A statement of whether the audit committee complied with its legal, regulatory or other responsibilities; and</li> <li>• A statement of whether the audit committee recommended the annual financial statements to the board for approval.</li> </ul>	

## 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.

## References

- Companies Act, 2008 (Act No.71 of 2008) (as amended by Act 3 of 2011)
- 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)
- 'State-owned companies: Companies Act, PFMA and King III in perspective Public Sector Working Group: Position Paper 1' (Joint publication: PricewaterhouseCoopers and Institute of Directors in Southern Africa) – June 2010

## How PwC can help you

### Assistance to the board

The Sustainable Business Solutions group within PwC offers a range of integrated solutions to assist leadership to meet the demands and expectations of their stakeholders. Tailored and relevant to your needs, these embrace:

- Independent, comprehensive leadership and committee evaluations;
- Thorough independent individual evaluations of office bearers including CEOs, CFOs, and other leadership positions;
- Review and development of leadership meeting and committee documentation;
- Review and development of leadership and committee systems and processes; and
- Companies Act and governance training.

### Assistance to the audit committee

PwC has specialists to assist audit committees fulfil their responsibilities relating to:

- External audit;
- Internal audit;
- Risk management;
- Internal financial control;
- Forensics;
- Embedded compliance; and
- Audit committee structures and charters.

### Other focus areas

PwC has expertise in a wide range of matters affecting SOC's, including:

- PFMA compliance review;
- Review of reporting against predetermined objectives; and
- SOC-specific governance assessments.

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