

LEARNING UNIT 4 THE KING IV REPORT ON CORPORATE GOVERNANCE IN SOUTH AFRICA

Duration: 108 minutes



LEARNING OUTCOME AND ASSESSMENT CRITERIA

The content of this sub learning unit is based on the following learning outcome and assessment criteria:

Learning outcome	Assessment criteria
<p>Exercise and analyse good corporate governance principles via effective and ethical leadership by the governing body towards achieving the following in any practical situation:</p> <ul style="list-style-type: none"> • Ethical culture • Good performance • Effective control • Legitimacy 	<ul style="list-style-type: none"> • Integrate, evaluate and assess corporate governance principles in any practical situation to address and achieve the following: <ul style="list-style-type: none"> ➢ Ethical culture ➢ Good performance ➢ Effective control ➢ Legitimacy
<p>Exercise statutory requirements in practical situations in the auditing profession.</p>	<ul style="list-style-type: none"> • Discuss and apply the statutory requirements to any practical situation.

ASSUMED PRIOR LEARNING



If you wish to refresh your knowledge, you may refer to your undergraduate material, prescribed textbook and the SAICA Handbooks. For your convenience, we provide textbook references, **but it is your responsibility to revise and work through (if needed) the content of this learning unit as it will not be repeated in this learning unit.**

Learning outcomes assumed to have been attained during prior learning	<i>Auditing Notes for South African Students (Auditing Notes) (12 th edition)</i>	<i>SAICA Handbook 2024/2025</i>
<ul style="list-style-type: none"> • Analyse and assess good corporate governance in any practical scenario by using the principles set out in the King IV report. 	<p>Chapter 4, section 4.1 to 4.2</p>	<p><i>SAICA student handbook 2024/2025</i>, volume 2B,</p> <ul style="list-style-type: none"> • Section 5: Governance – part 1 to 7



The table above provided you with the learning outcomes for this learning unit as well as references to your undergraduate material should you need to refer to it.

However, the table below provides a breakdown relating to the of the content mentioned above relating to the SAICA Student Handbook 2024/2025. The table below provides the sub-content for the references mentioned above which will assist you when working through questions. You should then flag and underline all the important sections and/or information in the SAICA Student Handbook 2024/2025, so that you can easily refer to the related sections and pages. The SAICA Student Handbooks 2024/2025 are also the only book that you can take into the exam venue, so it will just be to your benefit to use these books during your studies and when working through the questions. This can also assist you when formulating your answers for all your formative(tests)- and summative assessments (examinations) in future.

SAICA Student Handbook, 2024/2025	Parts
Volume 2B - Section 5	
KING IV Report on Corporate Governance for South Africa 2016	Part 1 to 5



4.1 INTRODUCTION

By now, you should be familiar with the concept of “corporate governance”, not only from your studies leading up to this point, but also from watching the news on television, reading the newspaper, browsing the internet, and the like. Unfortunately, companies are in the news for the wrong reasons, displaying a lack of good “corporate governance”.

Companies are an integral part of society (as corporate citizens) and we are all linked to companies in various ways, ranging from buying shares in a company to living in the same city or neighbourhood that a company operates in. It is for this reason that companies should operate in a manner that is responsible to society. King IV aims to promote a culture of good corporate governance in the South African environment.



COMMENT

You should familiarise yourself with the content of the King IV Report. as well as the explanatory notes in *Auditing notes* that were covered in your undergrad studies before attempting questions relating to the King IV report which includes all the principles. By just browsing through the principles and the recommended practices, you will struggle to identify all the related issues and link them with the applicable principles and recommended practices.

King IV is included in the *SAICA student handbook*, volume 2B. This is good news, as in terms of the open-book policy of SAICA, you may have this book with you when writing a test or examination. This will also make it easier when answering questions. However, because King IV is an open book, you can also expect a greater focus on application thereof in the questions. It is therefore of vital importance to ensure that you are able, firstly, to identify the related principles you are dealing with as discussed in part 5 of the King IV Report, secondly, link them with the applicable recommended practices and, lastly, make them applicable to the scenario.

A few things to note when attempting questions for this learning unit when preparing for your tests and examinations for tests and/or examinations:

- Corporate citizenship (achieved by ethical and effective leadership) are underpinning philosophies of good corporate governance. In a test or exam, it is important to evaluate whether lack of good corporate governance in one of the other areas of the Code, for example a lack of evaluation of the governing body's performance (principle 9), relates to the governing body not leading in an ethical and effective manner.
- The term "value creation process" is an important concept in King IV. It is defined as follows: "The process that results in increases, decreases or transformations of the capitals caused by the organization's business activities and outputs. For an explanation on "the capitals", refer to Auditing Notes from your undergraduate studies.
- Always evaluate the composition of the governing body and its sub-committees based on the recommended practices of King IV. A small number of marks will usually be allocated to the composition of these committees, which are relative easy marks to score in a test or exam, unless it is specifically excluded as per the required section.
- When the composition of the governing body is evaluated, one should take into account regulatory requirements, for example the JSE listing requirements dictates that listed companies must appoint a financial director to the governing body and in terms of Regulation 43 of the Companies Act, a social and ethics committee should be appointed in certain cases.
- Some students find the concepts **independence** and **being a member of one of the board committees** confusing.

Board committees comprise of **members of the board**, in other words appointed directors of the company. A person is therefore first and foremost a director of the company, appointed to serve on one or more of the committees of the board. The audit committee for example, should comprise only **independent**, non-executive directors. A non-executive director's **independence** is determined by the characteristics as set out in the Code (principle 7, recommended practices 25 to 29 and refer to Auditing Notes from your undergraduate studies) and a not by the fact that he or she serves on a board committee.

Below is a summary of the committees' composition recommendations:

Committee	Members	Number of members	Chairman
Audit	Independent, non-executive directors	At least 3	Independent, non- executive director
Nominations	Non-executive directors, majority should be independent. Chairperson of the board should be a member	At least 3	Chairperson of the board may be elected as chairman
Risk	Executive and non- executive directors, majority whom are non-executive. Chairperson of the board may be a member	At least 3	Chairperson of the board may be elected as chairman

Committee	Members	Number of members	Chairman
Remuneration	Non-executive directors, majority should be independent	At least 3	Non-executive director Chairperson of the board should not be elected as chairman
Social and ethics	Executive and non-executive directors, majority whom are non- executive. Chairperson of the board may be a member	At least 3	Chairperson of the board should not be elected as chairman



EXAMINATION TECHNIQUE

- Please note that when a question refers to the term "corporate governance", it implies that you must consider King IV. In addition, you may need to consider corporate governance issues arising from other sources (e.g. the Companies Act, Insider Trading Act, business ethics).
- Corporate governance is very topical and will therefore be examined on a regular basis.
- As mentioned earlier in this study unit, you have the King IV document at your disposal when writing a test or examination. Therefore, ensure you are familiar with the content of the document to enable you to find the relevant sections without wasting too much time.
- Corporate governance can be integrated with more than one topic. In preparing for tests and examinations, always envision how the aspects from King IV can be linked to other topics within auditing (especially with the Companies Act), as well as with your other subjects.
- Corporate governance can be integrated with more than one topic. In preparing for tests and examinations, always envision how the aspects from King IV can be linked to other topics within auditing (especially with the Companies Act), as well as with your other subjects.
- Good examination technique includes reading carefully what is required of you. If you are required to identify instances of **non-application** of King IV, do not waste time by mentioning instances where the entity in question has applied King IV (a common mistake that students make).
- It is very important that you do not make assumptions from the facts given to you, except when you are instructed to do so. By making assumptions, you are wasting valuable time by providing information that will not earn you marks.
- As with any of the other topics in auditing, the best way to study this section on corporate governance is to establish a good theoretical basis and then to attempt as many questions as possible.

(Source: Adapted from *Dynamic auditing*; 12th Edition; Marx, Van der Watt, Bourne)

4.2 LEARNING ACTIVITIES

After you have read the sections set out above, complete the following two comprehensive activities:



Activity 4.2.1 ~ 20 marks (duration 60 minutes)

Activity 4.2.1 marks	Estimated time		
	Writing	Marking and review	Total
20 marks	40 minutes	20 minutes	60 minutes



Please note that the “comments” provided in brackets below, are linked to the corresponding number in the suggested solution. They are provided to assist you in making the link between the given information and the suggested solution.

You are an audit senior at Malemela & Company (Malemela), a firm of registered auditors and have been assigned to the 30 June 2016 year-end audit of Bizniz (Proprietary) Limited (Bizniz). Bizniz imports a wide range of photocopying, facsimile and printing machines.

During the review of the audit file, you became aware of the following:

1. Statutory matters

A second-year trainee on the audit performed a statutory review of Bizniz and prepared working paper B1/1.

Client	Bizniz (Pty) Ltd	Prepared by	Second-year trainee	B1/1 Page 1 of 1
Year end	30 June 2016	Reviewed by	KT	
Subject	Statutory matters			

1. Board of directors (comment 1.1)

- Karen Wells – CEO and chairperson (comment 1.2)
- Bob Cilliers – Finance director
- Violet Mguni – Operations director
- Jane Witfield – Marketing director*
- Christo van Tonder – Human resource director
- Samuel Jackson – Professor in the Auditing Department at Unisa*
- William Smith – Government official (only attends board meetings)

* Appointed during the current year. Lead independent director.

Bob, Violet and Christo have served on the board for the past three years.

The audit committee is responsible for the evaluation of the board's performance (comments 1.3 and 1.4). These performance evaluations form part of the determination of the board's development and of the training needs of directors.

The board meets as and when required, and the board committees, as discussed below, meet annually.

2. Internal audit

- Internal audit reviews the implementation of the risk management plan on an annual basis (comment 2.1).
- Jane Witfield heads the Internal Audit Department (comment 2.6) and reports to Bob Cilliers, the finance director, annually (comments 2.2 and 2.5).
- Internal Audit identifies all the potential risks that Bizniz faces and makes decisions on how these risks will be mitigated (comments 2.3 and 2.4).
- Internal Audit is responsible for the preparation of the financial statements (comment 2.7).

3. Committees

Audit committee (comments 3.1 and 3.2)

- Violet Mguni
- William Smith
- Bob Cilliers

During the meeting of the audit committee held on 15 May 2016, it was decided that Bizniz would acquire shares in Africa Coal, a coal-mining company listed on the JSE Ltd. A detailed analysis of the coal-mining sector supported this decision (comment 3.3).

Risk committee (comments 4.1 and 4.2)

- Christo van Tonder
- Samuel Jackson

The risk committee was dismissed during the year (comment 4.3).

During the current financial year, the company had only the above-mentioned board committees in place (comment 4.3).

REQUIRED	Marks
Based on your review of working paper B1/1, comment on the information presented in terms of the requirements of King IV. (Note: compliance and non-compliance)	20

(Unisa Test – adapted)

SUGGESTED SOLUTION

1. Board of directors

- 1.1 The board should comprise a majority of non-executive directors. The majority of non-executive directors should be independent. **(principle 7, recommended practice 8)** (1)
- All the non-executive directors are independent, and this complies with the King IV code. (1)
 - There are five executive directors and two non-executive directors, and therefore not a majority of non-executive directors. (1)
- 1.2 Karen Wells fulfils the roles of both CEO and chairperson **(principle 2.16, recommended practice 31)** (1)
- These roles should be fulfilled by different individuals. (1)
 - The chairperson should be an independent non-executive director. (1)
- 1.3 The board should assume responsibility to evaluate its own performance, not the audit committee **(principle 9, recommended practice 71)**. (1)
- 1.4 The lead independent non-executive director should evaluate the chairperson **(principle 9, recommended practice 71)**, and the board should evaluate the CEO **(principle 9, recommended practice 82)**. (2)

2. Internal audit

- 2.1 The board should be responsible for the review of the company's risk management plan, not internal audit **(principle 11, recommended practice 3)**. (1)
- 2.2 In terms of sound corporate governance principles, Jane Witfield should report **administratively to the CEO and functionally to the audit committee**. At Bizniz, **Jane reports to Bob Cilliers, the finance director (principle 15, recommended practice 56)**. (2)
- 2.3 The board should be responsible for the governance of risk; as a result it should identify all potential risks that Bizniz faces and decide how these risks will be mitigated, not internal audit **(principle 11, recommended practice 1)**. (1)
- 2.5 Jane must also have access to the chairperson of the board and audit committee, respectively **(principle 15, recommended practice 53)**. (1)
- 2.6 The head of internal audit is the marketing director and may not have sufficient experience and knowledge **(principle 15, recommended practice 52)**. (1)
- 2.7 Management should be responsible for the preparation of the annual financial statements (AFS), not internal audit **(principle 5, recommended practice 9)**. (1)

3. Audit committee

- 3.1 In terms of King IV, the audit committee should comprise at least three members; Bizniz has three members, which complies with the King IV Code **(principle 8, recommended practice 46)**. (1)
- 3.2 All members should be independent non-executive directors **(principle 8, recommended practice 56)**; two members of the committee are not independent, non-executive directors, as they are involved in the day-to-day running of the business. (2)

- 3.3 As part of risk management, the audit committee cannot make decisions on the acquisition of shares in Africa Coal. This should be the responsibility of the board (with the approval of shareholders). (1)

4. Risk committee

- 4.1 The risk committee should consist of a minimum of three members (**principle 8, recommended practice 46**). (1)
- The composition of the risk committee does not comply with sound corporate governance, as it only has two members. (1)
- 4.2 The members can be executive and non-executive directors (**principle 8, recommended practice 64**). (1)
- 4.3 Dismissing the risk committee can be seen as an irresponsible act by management and it does not comply with corporate governance due to the following reasons: (1)
- The risk committee is an important part of integrated reporting that allows the company to report to all stakeholders on the sustainability of the company. (1)
 - Part of this is commenting on the major risks facing the company and explaining how to deal with these risks. (1)
 - King IV requires that the company establish audit, risk, remuneration, nomination, social and ethics committees (**various recommended practices**). (1)
 - The company did not comply with this requirement, as it only had an internal audit and audit committee and dismissed the risk committee. (1)

Available 27

Maximum 20



Activity 4.2.2 ~ 16 marks (duration 48 minutes)

Activity 4.2.2 marks	Estimated time		
	Writing	Marking and review	Total
16 marks	32 minutes	16 minutes	48 minutes

C2C (Pty) Ltd ('C2C') is a passenger bus company operating between all major cities across South Africa. It offers luxury long-haul intercity travel. The company credits its past success to its fleet of buses being equipped with safety equipment, air conditioning and heating, as well as audio entertainment. Recently, C2C has been experiencing financial difficulties caused by a range of new alternative competitors entering the market, which include intercity trains, lowcost airlines and long-distance minibus taxis. The year end of the company is 31 December.

C2C's board of directors has tried to keep the company afloat through the implementation of various strategies, but the company is still facing significant financial difficulties. These include declining revenue, volatile profit margins and a large debt burden. The Covid-19 pandemic, with the resultant travel restrictions that were imposed, severely worsened the situation.

The board of C2C recently convened to discuss progress made on the turnaround strategy of the company. Extracts of the minutes of that meeting are presented below:

Extracts of the minutes of the board meeting: 10 November 2021:

Matters discussed 1

1. As initially discussed during the prior board of directors' meeting (held on 20 September 2021) the following strategies were to be implemented to help the business recover
 - 1.1 Restructuring: certain non-profitable bus routes were to be closed down.
 - 1.2 Retrenchments were to be implemented in respect of a portion of the labour force, specifically bus drivers on closed routes.
 - 1.3 Funding of R40 million was to be obtained from a bank to assist with short-term liquidity and with investments in new buses. New buses should provide C2C with a competitive edge.
2. Performance evaluation.

Report back

1. The chief financial officer (CFO), Palesa Vuma, reported back on these matters as follows:
 - 1.1 Restructuring

Non-profitable bus routes were closed down in all nine provinces. A number of the buses on these routes were transferred to more profitable routes, while the rest are not being used at present. During December 2021, one bus was sold to Bus Repairs (Pty) Ltd ('Bus Repairs'), a company that services and repairs buses. As the company is owned by my father-in-law, I was able to negotiate a good sales price on the bus. A maintenance agreement in terms of which Bus Repairs will service all C2C buses for the next five years was included in the sales contract. As you know, our previous maintenance provider was liquidated recently, and therefore C2C would have had to open a tender process for a new maintenance provider if I had not found this brilliant solution. A tender process is now not needed at all, and thus I believe that this agreement has saved us a lot of time (and money). It's a win-win situation!
 - 1.2 Retrenchments

As a result of the restructuring, several bus drivers had to be retrenched. The bus drivers felt that they were unfairly dismissed and are now taking us to the Commission for Conciliation, Mediation and Arbitration (CCMA). They are requesting higher retrenchment packages and arguing a case for unfair dismissal. We have hired some of the best labour lawyers in the industry and I anticipate this situation to be resolved shortly.

Furthermore, earlier in the year the bus drivers went on strike because they were unhappy with the wages they earned, which were 20% lower than the industry average. Several buses sustained damage during the strike. Fortunately, our insurance covered the bulk of the repair costs.

Luckily, the trade union was able to negotiate with the bus drivers, the strike was halted, and the bus drivers returned to work. I had instructed the chief operating officer to offer the head of the trade union a bursary for his daughter to study in the United Kingdom next year. They know each other very well and play golf together on a regular basis. The bursary is C2C's way of thanking the trade union leader for all the good work he has been doing over the years.
 - 1.3 Funding

1.3.1 Innovation Bank

C2C applied for an additional loan with our banking provider (Innovation Bank) during October 2021 to fund a R40 million capital investment. This was required to implement the business recovery strategies and to ease short-term liquidity pressures. The loan was denied. Innovation

Bank stated that C2C is already in danger of defaulting on the renegotiated debt-equity ratio covenant of 1,6:1 on its current loan. The covenant was renegotiated (increased from 1,4:1) in 2020 to provide temporary relief to C2C after the initial lockdown regulations were put in place. Should the covenant be breached again, the full loan will become payable immediately.

Innovation Bank advised C2C to rather raise equity to fund its investment, which will result in an improvement in the debt-equity ratio.

1.3.2 Rights issue

I have decided that the best course of action is to follow the recommendation of Innovation Bank and to issue sufficient shares to fund the capital investment.

To ensure adherence to appropriate internal due process, I will prepare an EBITDA multiple based valuation of C2C. This will also serve as motivation to us, as the directors who own a large shareholding in CTC, to exercise our rights in the planned capital raise.

We will probably have to price the rights issue at an appropriate discount to entice all the existing shareholders to exercise their rights. I must note that, if all shareholders do not take up their full rights, it could affect the control of the company. I therefore want to suggest that any members of this board who are not able to take up their rights sell their rights to me; this will ensure that control remains in our hands.

2. Performance evaluation

Although my update provides an overview of the success of the various strategies, I do think that this should be assessed in a proper ratio analysis.

- 2.1 Net profit margin (%)
- 2.2 Interest cover (x)
- 2.3 Assets to equity (%)
- 2.4 Interest cover (x)
- 2.5 Debt to equity (%)

I believe these will give us a good indication of the quantitative level of success achieved on these strategies and interventions to date.

REQUIRED:	Marks
Discuss, with reference to the above, the corporate governance concerns you may have regarding the conduct of C2C's directors with reference to the King IV Report and the Companies Act.	15
Communication skills – clarity of expression	1

SOLUTION

The governing body should be ethical and provide effective leadership according to principle 1 of King IV.

- This principle is not being adhered to, as C2C directors are not being transparent in its dealings and are not acting with integrity (they are effectively paying a bribe to the trade union leader). (1)
- This is also evidenced by the CFO circumventing the tender process and other directors being silent on the matter. The governing body should assume responsibility for ethics within the organisation, creating an ethical culture as per principle 2 of King IV. (1)
- The directors do not appear to be instilling ethics in the organisation and the 'tone at the top' appears questionable, for example, C2C remains silent on the matter of the bribe. First, a bribe is not ethical, and (1)
- Second, they are not handling or reporting the bribe, which does not create an ethical culture. The governing body should ensure that the organisation is and is seen to be a responsible corporate citizen as per principle 3. (1)
- This principle does not appear to be followed in view of the organisation paying their bus drivers less than market rates. (1)
- Furthermore, rather than dealing with the unhappiness of the work force, C2C resorted to a bribe to silence the matter. (1)
- This also leads to the company being in breach of principle 14, requiring fair remuneration within the organisation. (1)
- There is also allegations of unfair dismissal and C2C is currently involved in CCMA proceedings. (1)
- The CFO did not disclose her personal financial interest or avoided making decisions in the bus sales transaction and is not being a responsible corporate citizen and acting with integrity. (1)
- Would also be in breach because directors are not following proper tender processes which will not be regarded as fair and honest. (1)
- The board's failure to "comply" with the last recommended practice under principle 4 of the King IV Code ("As part of its oversight of performance, the governing body should be alert to the general viability of the organisation with regard to its reliance and effects on the capitals, its solvency and liquidity, and its status as a going concern") (1)

Principles 7 & 8 of the King IV envisage a balance of power in the effective and ethical steering of the company:

- However, it appears as if the CFO is making all the key decisions on behalf of the board of directors. (1)
- The CFO can be seen as the dominant force on the board (as none of the other directors are challenging her decisions (based on extracts from minutes) even though they are not in compliance with the Companies Act and the decisions are unethical. (1)
- The CFO also ordered the rest of the board to sell their rights to her without considering their intentions with the rights issue. (1)

Principle 13 requires the board to govern in compliance with laws and regulations. This principle is in breach due to the following (C2C is in breach of the following Companies Act sections (thus breach of principle 13):

- S22: The company is not liquid, has a large amount of debt and is planning on borrowing additional funds. This could be considered reckless trading as the company may not be able to settle its debts as they become due and payable. (1)
- Linking S22 to Principle 4.8 relating to the boards oversight of its performance that specifically relates to being “alert” to the viability and liquidity and solvency of the organisation. (1)
- S38: The CFO unilaterally decided to issue more shares. Therefore, appropriate approvals were not received for the issue of shares (i.e. board resolution) (1)
- S39: the entity is private company the issuing of shares should be done in proportion of the existing shareholding, i.e. the rights must be equally awarded. (1)
- S40: which speaks to adequate consideration – This is not the case here especially with the company facing liquidity problems. As the CFO seem to have more power and also has interest in buying more, they could possibly be sold at a big discount as this would mean savings for him. (1)
- S36: It does not appear as if a special shareholders resolution has been obtained to change the MOI to allow for the rights issue. (1)
- The CFO has personal financial interest (father-in-law owns the business) in the sale of the bus transaction and awarding of the maintenance contract, therefore she should not have been part of the decision making. (1)
- S76: Based on the CFO’s behaviour, it is clear that the directors are not acting in the best interest of the company. They are thus in breach of their fiduciary duties. (1)
- E.g the CFO is using her position to benefit a family member and would therefore be gaining an advantage over the company. (1)
- S77: Directors can therefore be held personally liable for any losses suffered by the company based on the above. (1)
- S112: Consideration should be given whether the restructuring would constitute the greater part of the business which would require a special resolution. (1)
- The non-compliance with the Companies Act could be an indication that the company possibly does not have a company secretary or that the person is not performing his/her duties properly. In accordance with King IV Principle 10 paragraph 90 the governing body must ensure that they have access to a professional corporate governance specialist/company secretary who can offer guidance to the governing body regarding legal obligations. (1)
- As the CFO makes decisions on behalf of all directors, this may also call into question the ability of the non-executive directors to be independent. If nonexecutive directors are not independent, this would then cause the board and sub-committee composition to not be appropriate. (1)

Communication skills – clarity of expression (1)

Available 28

Maximum 16