

CORPORATE GOVERNANCE INDEX 2014



**The Institute of
Internal Auditors
South Africa**



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FOREWORD



It is my pleasure to present the IIA SA's second edition of the Corporate Governance Index – *An Internal Audit Perspective*.

This unique perspective is one that we hope will be valued for what it is – the insightful and considered opinion of senior internal audit professionals, steeped in the Standards of objectivity and independence that is the hallmark of the profession. Through the research survey we were able to obtain the views of Chief Audit Executives (CAEs) regarding the state of governance within their organisations, and ascertain what their key priorities are for the near future.

The ever-growing importance of corporate governance and risk management in both business and public sector environments means that oversight bodies such as boards and audit committees have placed huge expectations on internal auditors to provide independent assurance on the adoption and implementation of processes. CAEs are in the privileged and sometimes perilous position of being both assurance provider and best practice advisor to management and the board on critical issues of governance. Their candid appraisals and recommendations can assist organisations to fix problems and identify opportunities that others may have missed.

The purpose of this report is to advance our understanding of our key strengths and weaknesses in the areas of corporate governance in South Africa. It is well known that we are a global leader in this field by virtue of the widely respected King Codes of Governance Principles. Our research investigates to what extent we have successfully implemented the world class guidance that the King Codes provide.

The research methodology underpinning the Corporate Governance Index has been improved since last year. This is due in large measure to our research collaboration with the Centre for the Study of Governance Innovation (GovInn) at the University of Pretoria, headed up by Professor Lorenzo Fioramonti. I would like to sincerely thank Professor Fioramonti and his team for their efforts and insights. My thanks also extend to all CAEs who participated in the survey. Without your willingness to share your views, this valuable Index would not have been possible.

It is my hope that the Index will prove helpful to organisational leaders across the country, and that it will stimulate reflection and debate. As always, we welcome your feedback!

Claudelle von Eck
Chief Executive Officer
The Institute of Internal Auditors South Africa
August 2014



EXECUTIVE SUMMARY

The IIA SA's Corporate Governance Index reflects the views of Chief Audit Executives (CAEs), who are well positioned to provide a relatively impartial view of the state of corporate governance in South Africa, as they typically provide independent assurance on governance, risk and control within the organisations they serve.

The second edition of the Index builds on the inaugural Index released in 2013, and is intended to provide a comparative analysis of the perceived performance of South African organisations in certain key dimensions of corporate governance. The Index, which was developed through the methodological assistance of the Centre for the Study of Governance Innovation (GovInn) at the University of Pretoria, provides a baseline for the measurement of performance for the entire country since it surveys all economic sectors¹. A slight change in research methodology has expanded the number of dimensions measured and will henceforth be applied consistently. The following critical dimensions were covered by the survey - Ethics, Compliance, Leadership, Risk Management (Operational and External Risks), Performance and Internal Audit.

1. The overall Country Index for Corporate Governance in South Africa fell from 3.2 in 2013 to 2.9 in 2014 (out of a maximum score of 4). This corresponds to a drop of 9.4%, which may indicate a perception that organisational performance in the area of corporate governance has declined somewhat over the past year.
2. The results show that organisational leaders are strongest at setting the right ethical tone required for the execution of good corporate governance, albeit that the index score for this dimension is slightly less impressive for 2014.
3. The most challenging areas of corporate governance for South African organisations seem to be Performance and Risk Management, in particular the identification of external risks, though organisations fare somewhat better at operational (or internal) risk management.
4. Also noteworthy is the perception that organisations are generally under-performing. The two weakest specific areas under the dimension of Performance are human resource management and Information Communications Technology (ICT) governance.
5. The greatest degree of negative change occurred in the dimension of Internal Audit, where respondents (i.e. Chief Audit Executives) feel that their leadership displays a lesser degree of understanding of their profession, and therefore places less value on the role of internal audit.

¹ The Centre for the Study of Governance Innovation (GovInn) is directed by Prof. Lorenzo Fioramonti and is located at the University of Pretoria. More information about GovInn can be found at www.governanceinnovation.org

RESEARCH METHODOLOGY

The core dimensions of corporate governance were identified and appropriate questions relating to each dimension were crafted. The survey consisted of three demographics-related questions, 23 multiple choice questions and one open-ended question. The 23 single response multiple choice questions were designed to cover the following dimensions of corporate governance: Ethics, Compliance, Leadership, Risk Management (i.e. Operational Risk and External Risk), Performance and Internal Audit. Each of the following potential responses was assigned a value as follows in order to aggregate scores into an Index that will be tracked over time:

0= strongly disagree; 1=slightly disagree; 2=neither agree nor disagree; 3=somewhat agree; 4=strongly agree

Six hundred Chief Audit Executives (CAEs) on the IIA SA database were targeted for the survey, which took the form of a self-administered web-based questionnaire. **CAEs at Professional Services Firms were specifically requested to report on a typical client**, rather than on their own firms. It was critical that the survey elicited the most honest responses possible. Consequently, no personal demographic data was asked for. Over a period of four weeks during May and June 2014, a total of 221 respondents completed the survey. It is important to note that the survey was slightly modified to cover additional dimensions; hence the comparison with 2013 is only partial.

SURVEY RESULTS

OVERALL RESULTS

Figure 1: Corporate Governance Index per dimension



Table 1: Index Scores

Dimension	2014	2013	% change
Ethics	3.3	3.4	-2.9%
Compliance	3.0	N/A*	-
Leadership	3.0	3.2	-6.3%
Operational Risk	2.8	3.0	-6.7%
Internal Audit	3.2	3.5	-8.6%
Performance	2.5	N/A	-
External Risk	2.1	N/A	-
COUNTRY CGI	2.9	3.2	-9.4%

Scale: 0 (lowest) to 4 (highest)

* N/A – Some 2013 indices are not available due to a change in the research methodology. In future all dimensions will be covered.

It is clearly evident that where comparisons can be made between 2013 and 2014, there is a perception that corporate governance in South Africa has worsened somewhat during the past year. This perception is also indicated by the decline in the overall Country Index from 3.2 in 2013 to 2.9 in 2014. Despite this decline, Ethics still emerges as the strongest and most positive variable in corporate governance. Conversely, the Index suggests that the greatest challenge for South African organisations lies in the area of risk management, and the management of external risks (2.1) in particular. Overall organisational performance was also disappointing, as it attained the second lowest score on the Index (2.5).

Table 2: Index per Economic sector

Sector	Index
National Government	2.7
Provincial Government	2.7
Municipal (Metro)	2.5
Municipal (District)	2.2
Municipal (Local)	2.3
State Owned Company	2.9
Publicly held company	3.2
Privately held large company	3.0
SMME	2.3
Non profit company	3.3
Professional Services Firm*	3.2

Scale: 0 (lowest) to 4 (highest)

*CAEs from Professional Services firms reported on their clients

Table 3: Index per Industry sector

Sector	Index
Agriculture/Forestry/Fishing	3.2
Health/Pharmaceuticals	3.5
Manufacturing (incl. Packaging & Printing)	3.0
Education and Training	2.5
Banking/Finance/Insurance	3.3
Logistics (Transportation/Building..)	2.5
Defence/Security	3.1
Wholesale and Retail	3.0
Mining/Quarrying/Energy/Oil/Chemical	3.0
Services (Community/Professional...)	3.3
Public Administration: public service	2.3
Tourism/Hospitality/Clothing/Food & Bev...	3.6
Technology (ICT/Telecom/Electronics)	3.2
Other	2.9

Chief Audit Executives at Non Profit Companies (3.3) were most positive about the organisation’s overall corporate governance culture and performance, followed by publicly held companies (3.2). (It should be noted that Professional Services firms also scored 3.2 but respondents in this sector reported on a typical client). SMMEs and the public sector are perceived by respondents as being weakest at corporate governance, with District Municipalities (2.2) being identified as having the most challenges in this regard. In terms of the industry sectors of our economy, the Tourism/Hospitality/Food and Beverage/Recreation (3.6) industries are the top performers according to respondents who work in those sectors. The Health and Pharmaceuticals industry (3.5) comes a close second. Public service respondents gave their sector the poorest rating which stands at 2.3.

Demographic data – i.e. economic sectors (%)

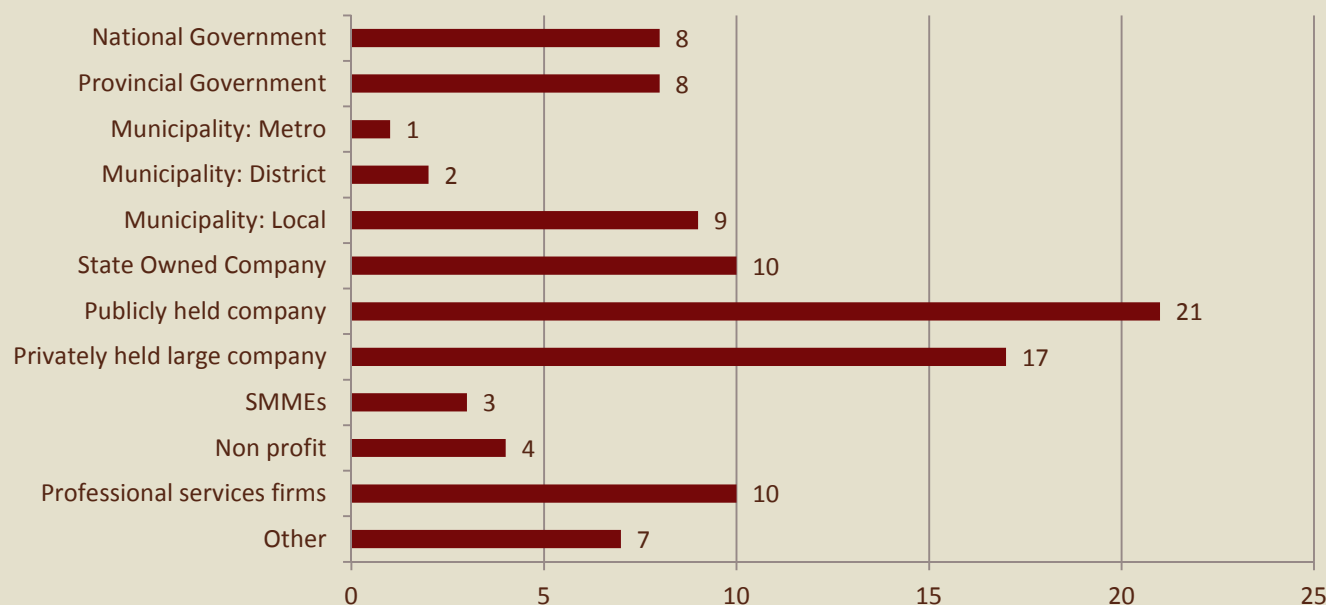


Figure 2: Economic sectors respondents work in (%)

RESULTS PER DIMENSION

ETHICS

Typical question: Ethics is an important part of our organisational culture

Figure 3: Breakdown of various responses (%)

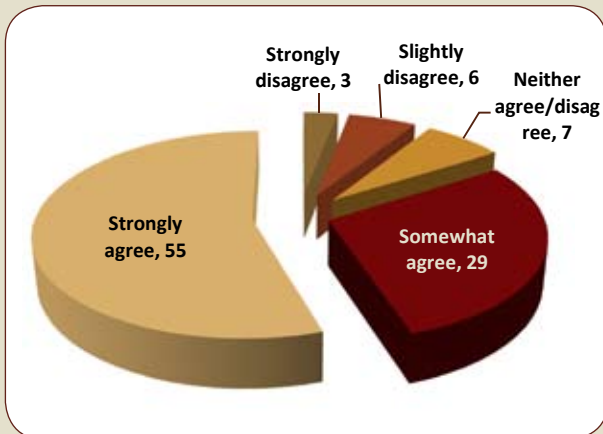
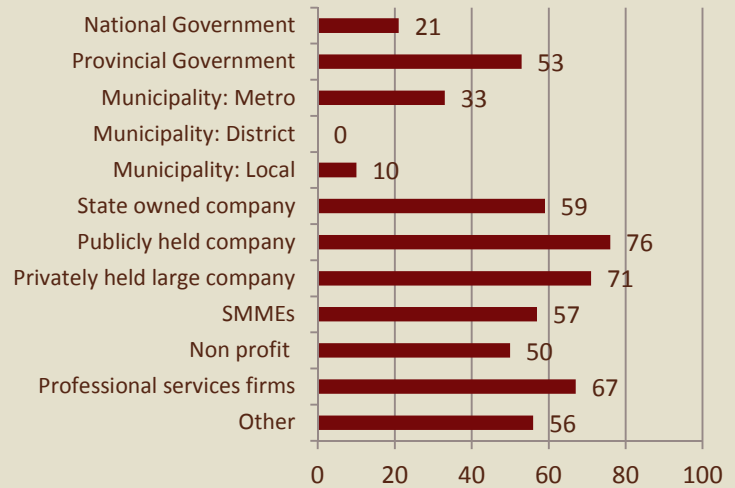


Figure 4: Respondents who strongly agree (% per sector)



Although respondents rated Ethics overall as the most positive aspect of organisational governance (3.3), this core dimensions rating is slightly lower than it was in 2013 (3.4).

COMPLIANCE

Typical question: Your organisation complies with relevant legislation, regulations and standards

Figure 5: Breakdown of various responses (%)

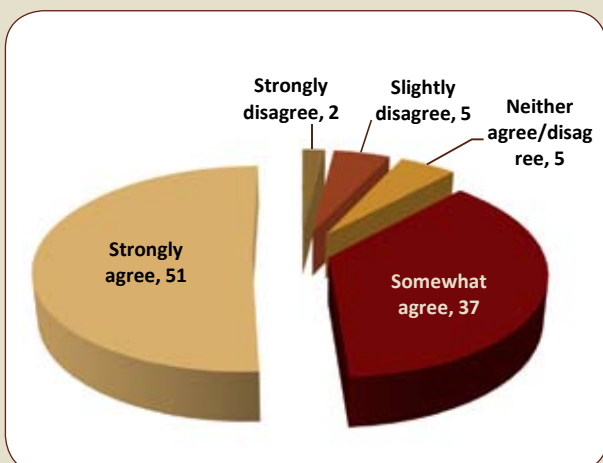
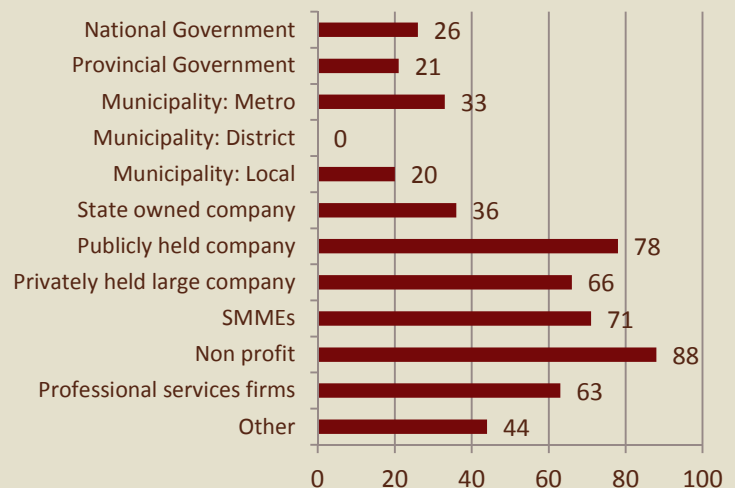


Figure 6: Respondents who strongly agree (% per sector)



Compliance received an Index score of 3.0. However, it is rather surprising that only 51% of respondents expressed strong confidence in their organisation's ability to meet their compliance obligations effectively. Furthermore, when asked whether their organisation "goes beyond a mere tick box exercise – i.e. there is a deep understanding of the principles and philosophy of good governance" only 29% strongly agreed that this was indeed the case. The concern around compliance matters was further confirmed in the open-ended question where Compliance was placed amongst the top 3 areas of emerging risk.

LEADERSHIP

Typical question: Your executive team is functioning optimally in delivering the strategy of the organisation

Figure 7: Breakdown of various responses (%)

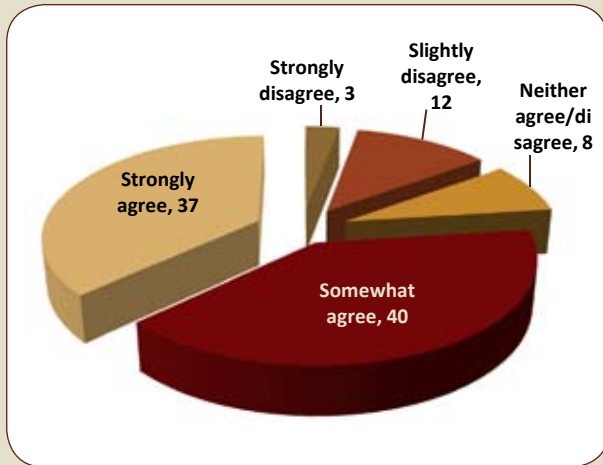
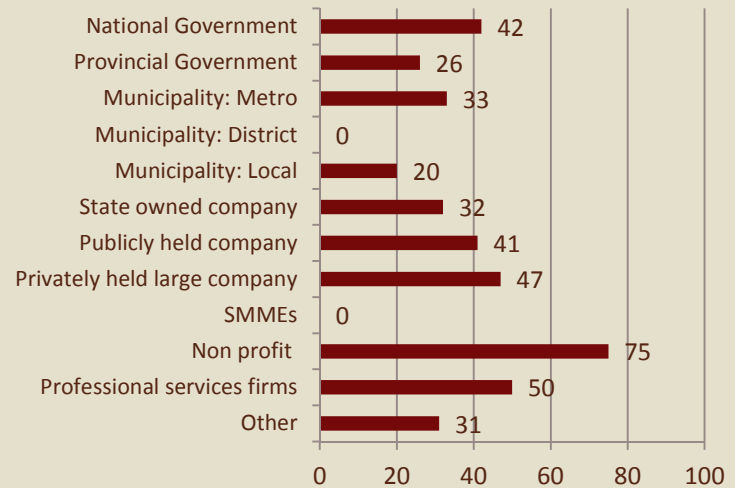


Figure 8: Respondents who strongly agree (% per sector)



The dimension of Leadership received an Index score of 3.0 compared to 3.2 in 2013. Regarding leadership, questions were designed to establish the perceived competence of organisational leadership, which includes senior and executive management as well as boards and audit committees. As the pie chart above indicates, only 37% of respondents consider their organisational leaders to be highly competent.

RISK MANAGEMENT

OPERATIONAL RISK

Typical question: The process of managing risks within your organisation is adequate

Figure 9: Breakdown of various responses (%)

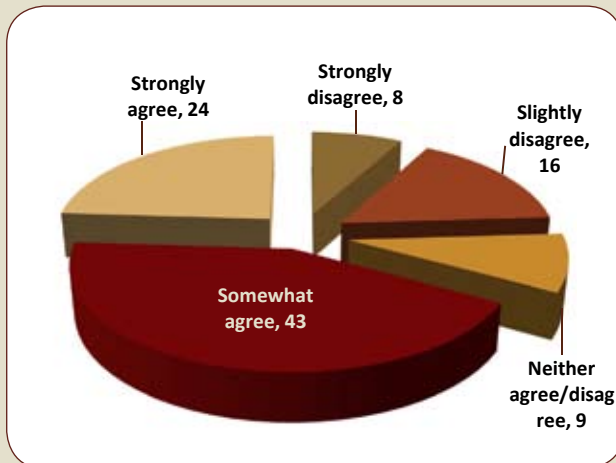
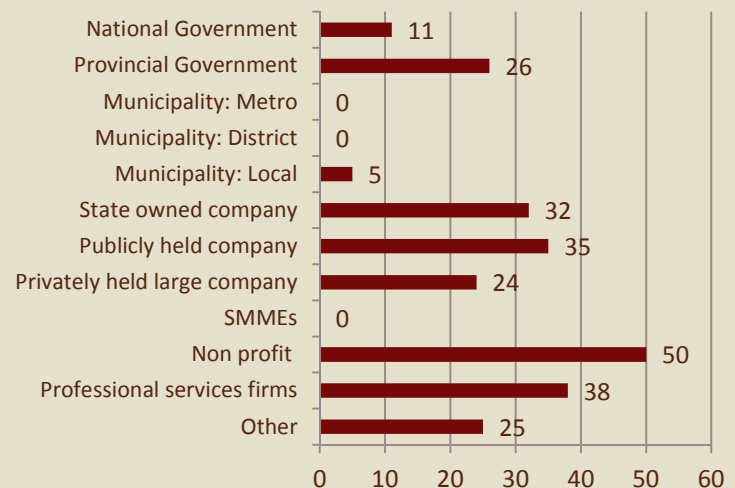


Figure 10: Respondents who strongly agree (% per sector)



EXTERNAL RISK

Typical question: Your organisation utilises scenario planning to mitigate against unexpected external risks that may arise well beyond the boundaries in which the organisation operates

Figure 11: Breakdown of various responses (%)

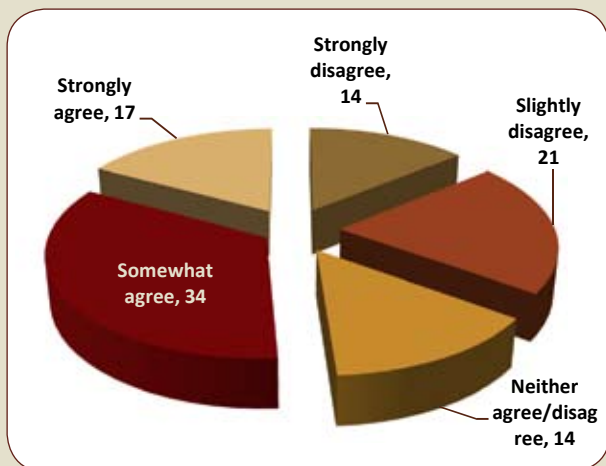
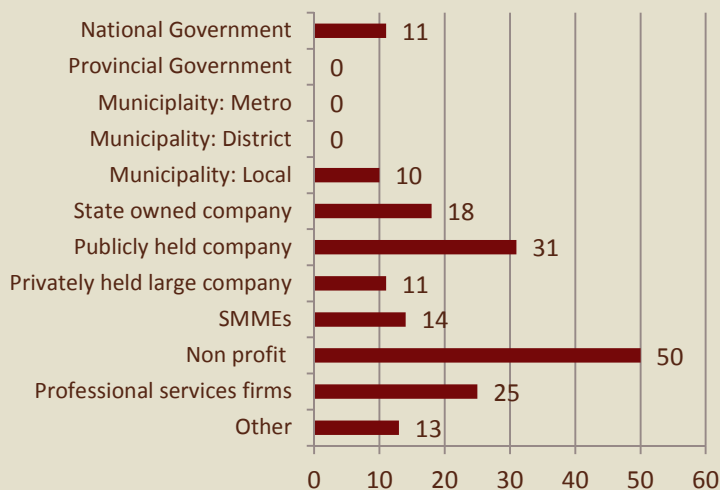


Figure 12: Respondents who strongly agree (% per sector)



Risk management continues to be an area of weakness. The management of internal or operational risk scores 2.8 on the Index whilst the management of external risks (2.1) suggest that this is an area where management should consider allocating more time. This is borne out by the fact that only 17% *strongly agree* that their organisations are utilising effective methods of anticipating external risks. There may be a correlation between the perceived deficiency in risk management competence and the relatively low ratings of performance and leadership ability.

PERFORMANCE

Typical question: ICT is aligned to the strategic objectives of your organisation

Figure 13: Breakdown of various responses (%)

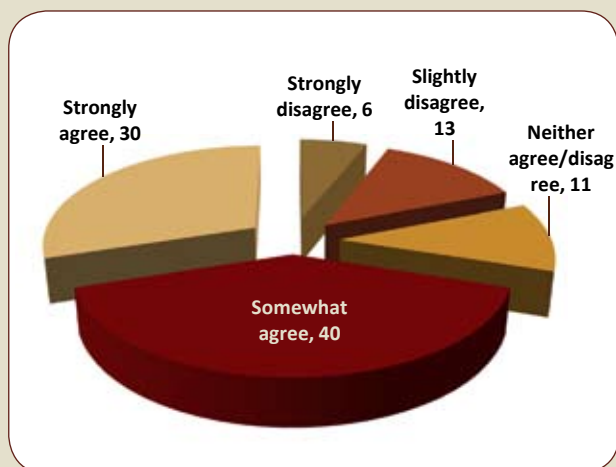
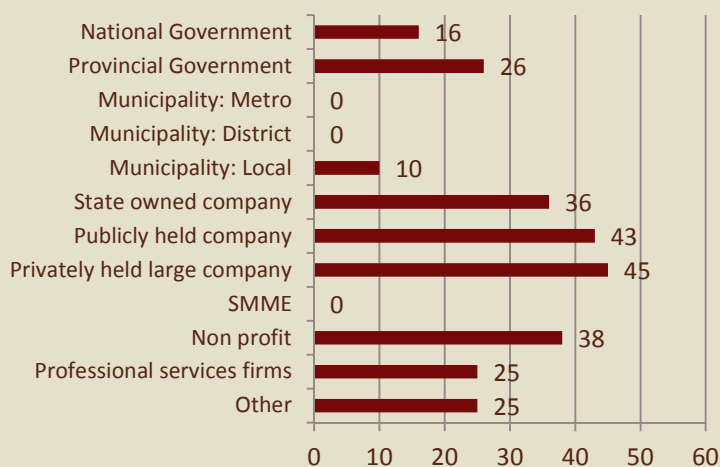


Figure 14: Respondents who strongly agree (% per sector)



The Index rating for Performance was fairly low at 2.5. Regarding this dimension, care was taken to include questions covering all 6 “capitals” relating to organisational performance i.e. Human, Financial, Social, Natural, Intellectual and Manufactured capitals. The two specific performance areas of greatest weakness were

Information Communication Technology (ICT) management and Human Resources as the pie charts above and below indicate. Responses to the open-ended question confirmed this trend, as Human Resource management came out as the top emerging risk, followed by ICT risks.

Typical question: Your human capital resources are optimally utilised

Figure 15: Breakdown of various responses

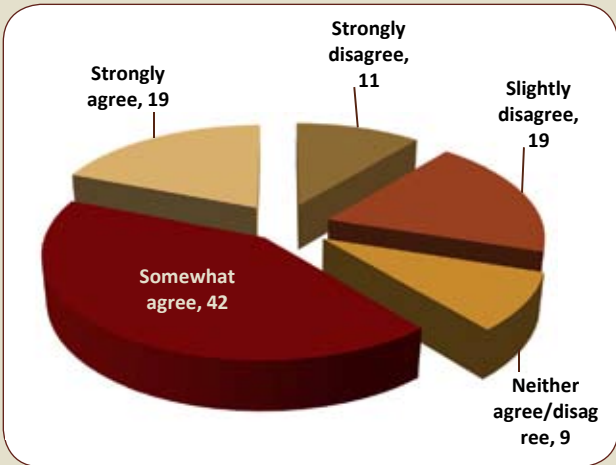
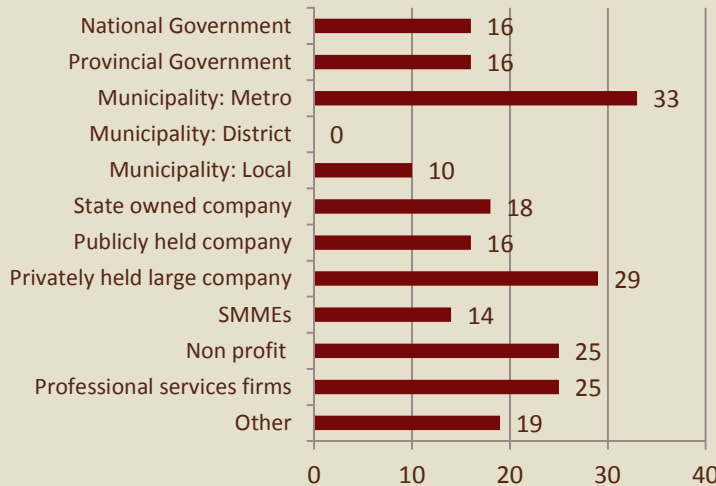


Figure 16: Respondents who strongly agree (% per sector)



INTERNAL AUDIT

Typical question: Within your organisation Internal Audit has a sufficient degree of independence to enable it to execute its duties without undue influence or interference

Figure 17: Breakdown of various responses (%)

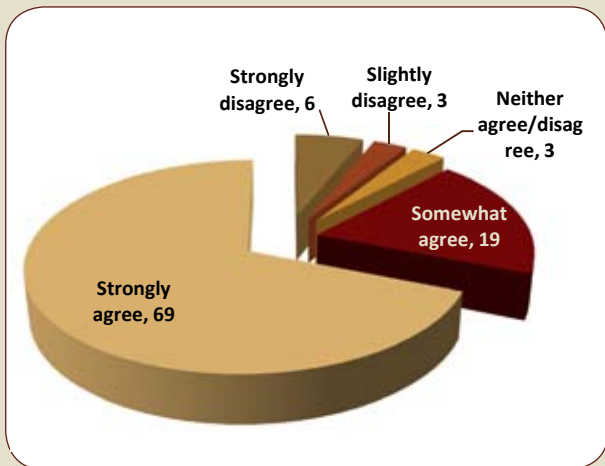
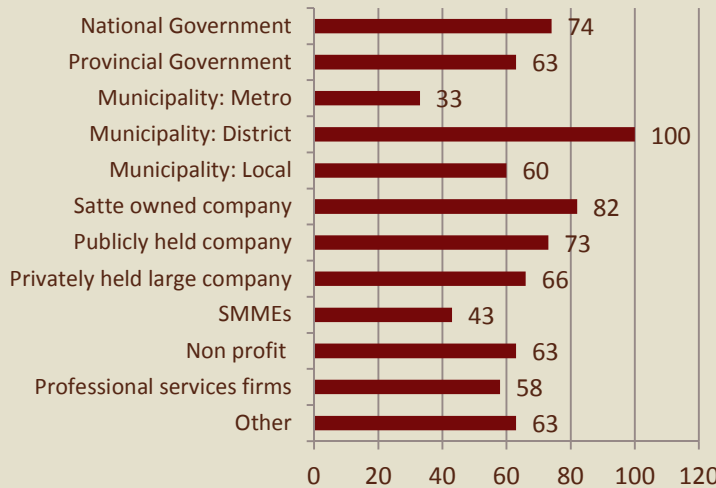


Figure 18: Respondents who strongly agree (% per sector)



Questions posed regarding internal audit were not in the nature of self-evaluation. Rather, they related to leadership’s understanding of and support for the role and value of internal audit as a key pillar in corporate governance. While the Index rating at 3.2 is relatively high, it is lower than the 2013 score of 3.5. Last year, for instance, 75% of CAEs agreed strongly that Internal Audit was accorded a “sufficient degree of independence” within their organisation, compared to 69% in 2014. Similarly, in 2013, 54% of respondents strongly agreed that their leadership had a good understanding of internal audit, as opposed to 38% in 2014.



MAIN FINDINGS

Below is a list of the most significant research findings:

1. The decline of the **Country Index** from 3.2 to 2.9 may indicate a growing perception that organisations are struggling to achieve effective corporate governance, and may be doing slightly worse than last year.
2. The Index results show that South African organisations are strongest at setting the right **ethical tone** (3.3) for the execution of good corporate governance – albeit slightly less well than last year (3.4).
3. It appears that organisations struggle most at identifying **external risks** (2.1), although they seem to do somewhat better at **operational** (or internal) **risk** management, having achieved a score of 2.9.
4. Compared to 2013 (3.2), respondents are slightly less impressed with the **quality of leadership** (3.0). For instance, only 37% of respondents *strongly agree* that organisational leaders are “*functioning optimally in delivering the strategy of the organisation*”.
5. The overall **Performance** Index for 2014 is 2.5. **Human Resource** management seems to be the weakest area. Only 21% *strongly agreed* that organisations had suitable human resources and 19% *strongly agreed* that human resources were being utilised optimally. The second weakest area of performance is ICT governance.
6. **Compliance** received a rating of 3.0 on the Index. In addition, only 51% of respondents *strongly agree* that their organisations comply with relevant legislation, regulations and standards.
7. Respondents feel that their leadership’s understanding of the role and **value of internal audit** (3.2) is slightly lower than it was the previous year (3.5).
8. The **top 5 areas of focus** over the next few years are, in order of priority: Human Resources; Information Communications Technology (ICT); Compliance; Ethics and Leadership; as well as Fraud and Corruption.

THE WAY FORWARD

The annual Corporate Governance Index is intended to present management, boards and audit committees with a credible perspective on emerging corporate governance trends in South Africa.

The overall findings suggest that organisations are becoming less effective at corporate governance. This should be an issue of concern to the leadership of all organisations. Internal audit as well as all other professions that contribute to good governance and organisational performance would do well to take note of these findings. It is hoped that professionals will engage in a process of self-reflection and enter into discussion with executive management and oversight bodies regarding the challenges raised in this report. While it is encouraging that the leadership in general strikes the right ethical tone for the implementation of good governance, it should be noted that respondents are questioning the effectiveness of leadership teams, as well as the management of human resources. Affected professions should also pay attention to trends in dimensions such as compliance, which is becoming ever more challenging. The same goes for risk management where South Africa, like most of the world, is struggling with external risk management and ICT governance.

The IIA SA takes the survey results seriously and will address relevant findings through training programs and discussions at its various conferences. As the Index becomes more widely distributed, we expect other related professions to start their own processes of internal dialogue and debate with a view to addressing the gaps that have been identified. After all, the findings reflect our collective ability to deliver value to our shareholders and stakeholders. The real power of this report therefore lies in our ability to translate knowledge into action.

APPENDIX 1: SUMMARY OF ANSWERS TO SURVEY QUESTIONS (%)

Dimension	Question	Strongly disagree	Slightly disagree	Neither agree/disagree	Somewhat agree	Strongly agree
Ethics	The Oversight body (such as the Board or Council), sets a clear tone of zero tolerance toward unethical behaviour, including fraud and corruption in your organisation.	4	5	4	23	64
	Ethics is an important part of your organisational culture.	3	6	7	29	55
Compliance	Your organisation is committed to implementing relevant good corporate governance principles (as outlined in King III or the National Treasury governance frameworks).	3	5	5	29	58
	When it comes to corporate governance, your organisation goes beyond a mere tick box exercise - i.e. there is a deep understanding of the principles and philosophy of good governance.	8	11	7	45	29
	Your organisation uses a combined assurance framework to provide a co-ordinated approach to assurance activities.	10	13	12	34	31
	Your organisation complies with relevant legislation, regulations and standards.	2	5	5	37	51
Leadership	Your Oversight body (such as the Board or Council) provides clear strategic direction to achieve the objectives of your organisation.	4	6	9	28	53
	The leadership of your organisation (i.e. senior and executive management as well as the Board) displays a good understanding of the varying roles of assurance providers (such as internal audit, external audit, risk management etc.)	4	10	10	41	35
	The Audit Committee is effective in its oversight role.	5	5	9	28	53
	The Audit Committee gives enough attention to all the dimensions within the ambit of its responsibilities.	5	7	9	30	49
	Your executive team is functioning optimally in delivering the strategy of the organisation.	3	12	8	40	37
	Your organisation has a social investment strategy.	14	12	15	33	26

Dimension	Question	Strongly disagree	Slightly disagree	Neither agree/disagree	Somewhat agree	Strongly agree
Operational Risk	The process for identifying risks is aligned to your organisation's strategic objectives.	3	9	8	36	44
	The process of managing risks within your organisation is adequate.	8	16	9	43	24
External Risk	Your organisation utilises scenario planning to mitigate against unexpected external risks that may arise well beyond the boundaries in which the organisation operates.	14	21	14	34	17
Performance	Information and Communications Technology (ICT) is aligned to the strategic objectives of the organisation.	6	13	11	40	30
	Your organisation has suitable human resource capital to execute its strategy effectively.	10	14	13	42	21
	Your human capital resources are optimally utilised.	11	19	9	42	19
	Your organisation has implemented an effective stakeholder management plan.	9	14	25	33	19
	Your organisation utilises its financial capital optimally (i.e. managing finances so as to achieve best outcomes).	8	15	8	33	36
	Given the current resources, your organisation's output/delivery is at optimal levels.	9	22	13	37	19
Internal Audit	Within your organisation Internal Audit has a sufficient degree of independence to enable it to execute its duties without undue influence and interference.	6	3	3	19	69
	The leadership in your organisation (i.e. senior and executive management as well as the Board/Council) displays a good understanding of the role of internal audit.	4	10	6	41	39



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