PRACTICENOTES

King III Chapter 2

Improving the functioning of the board through the performance of the social and ethics, risk and audit committees

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Introduction

In terms of the King Report on Governance for South Africa 2009 (King III) the board is the focal point of corporate governance and should therefore lead, amongst other things, on:

- ensuring that the company is, and is seen to be, a good corporate citizen (which will only be achieved if the company has regard for sustainable development)
- ensuring that the company's ethics are managed effectively
- ensuring that the company has an effective and independent audit committee that should, inter alia, oversee integrated reporting
- being responsible for the governance of risk, and
- ensuring the integrity of the company's integrated report

To assist the board in fulfilling its role, King III recommends the delegation by the board of certain functions to well structured committees, but without abdicating its own responsibilities.

Whilst each organisation needs to determine its own needs in terms of which board committees it wishes to constitute, an audit committee is a statutory requirement for:

- state-owned companies;
- public companies;
- other companies that are required by their Memorandum of Incorporation to have an audit committee.

For those companies for which it is not mandatory to have an audit committee, King III recommends that an audit committee be established as a matter of good governance and in addition thereto, that all companies set up risk, remuneration and nomination committees as standing committees.

The Companies Act 2008, read together with the related regulations, also contemplates that a social and ethics committee be established for state-owned companies, listed public companies and certain other companies depending on their public interest score. This legislative requirement is closely aligned to King III's increased focus on ethics and sustainability.

The role of this committee includes monitoring of social and economic development, good corporate citizenship, the environment, health and public safety, consumer relations and labour and employment.

The purpose of this practice note is to provide guidance on best practice with regard to the establishment, composition and mandates of the audit committee in relation to the social and ethics and risk committees and also to address role clarity and feasibility of combining committee duties.

Terminology

In order to understand the duties of the board committees dealing with audit, integrated reporting, risk and sustainability, it is necessary to clarify what is meant by these terms and functions.

Sustainable development means that sustainability should be integrated with strategy and operational performance, by considering how sustainability is to be assimilated within the operations of the company in such a way that these promote the company's long-term strategic objectives. It involves that the company should be assessing sustainability risks and determining the appropriate response thereto as part of strategy setting and also in the execution of that strategy consider the impact of its operations on the natural environment and society.

Sustainable development deals with improving the organisation's ability to perform in a balanced manner regarding the triple context – economic, social and environmental performance. Embedded in the concept of the triple context are the matters of corporate citizenship and responsible leadership.

Integrated reporting refers to a holistic and integrated representation of the company's performance, i.e. the financial performance is contextualised by reference to social and environmental performance. In this way the reporting on economic, social and environmental performance are integrated to provide stakeholders with a more holistic and balanced view of the company's performance.

Financial reporting is assured through external audit. The requirement that reporting needs to take place within a triple context of economic, environmental and social (i.e. integrated reporting) means that the whole report is to carry equal weighting and needs to be assured.

Risk is defined in King III, as uncertain future events that could influence both in a negative and a positive manner, the achievement of the company's objectives.

All of the above matters need to be governed by the board and its committees and it is necessary to understand how this oversight role is to be structured vis-a-vis the board and the relevant committees.

Board and board committee functioning

A board committee is one mechanism that assists the board to fulfil its role and obligations. The board remains the focal point of corporate governance and in establishing board committees, the board's ability to provide responsible leadership on all governance matters in an integrated manner should not be diluted.

Board committees should therefore not function in silos and their outputs should be consolidated at board level.

The ultimate test for well functioning board committees is therefore the extent to which board performance is improved with regard to fulfilling its role, rather than focusing only on the effectiveness of a particular committee. An effective process must therefore integrate the contribution of board committees at board level.

Each company should, depending on size, nature and complexity, decide on whether and how the duties, with regards to sustainability, risk and integrated reporting, should be shared by board committees. .

Audit Committee

[Refer to chapter 3 of King III for a comprehensive discussion on the role of the audit committee and its statutory duties]

The audit committee's primary role is to provide independent oversight of the:

- external and internal audit processes;
- combined assurance model and
- reliability and integrity of integrated reporting.

Whether or not a separate risk committee has been established, the audit committee also plays an integral role in the risk oversight process in so far as this impacts on assurance processes and integrated reporting. Therefore, even if a separate risk committee is in place, in executing this role it is necessary that the audit committee should have a sound understanding of the following areas of risk:

- financial and sustainability reporting risks;
- the nature of the risks that are being mitigated through the implementation of the various internal financial controls;
- fraud risks as they relate to reporting; and
- IT risks as they relate to reporting.

The audit committee should also understand risk from the perspective of it forming the basis of the combined assurance and audit plans that are to be approved by the audit committee.

As far as integrated reporting is concerned, the audit committee should oversee credible disclosure and to this end evaluate the integrity of the company's management of its social and ethics programmes.

In relation to this, the audit committee should ensure that:

- material issues are identified and that the information is reliable and no conflicts arise when compared to the financial results;
- assurance processes are developed for environmental, social and governance matters and that engagement at an early stage takes place with the auditors and other external and internal assurance providers to determine the aspects of the integrated report that are to be subject to audit or assurance.

The audit committee should perform its role as a reporting oversight committee, as opposed to the social and ethics and risk committees who have a wider mandate respectively, to govern company performance with regards to risk and sustainability.

For example, if the audit committee sets sustainability performance targets, it will not be in a position to then evaluate if such performance targets have been achieved for reporting purposes. Similarly, if it establishes or approves a risk management process, it may not be able to evaluate the efficacy of the risk management process through assurance over the controls.

In essence, some of the outputs from both the risk and social and ethics committees will be subject to the oversight of the audit committee – some examples are provided below under each committee respectively.

It is to be noted that the board and all board committees function at a strategic level and can never be management or operational committees. Nevertheless, it can be said that the audit committee functions at an elevated level of oversight than other board committees due to its role in assurance and integrated reporting and due to the fact that it utilises output from the other committees to perform its oversight responsibilities.

Risk Committee

[Refer to chapter 4 of King III for a comprehensive discussion on the role of the risk committee]

The overall function of the risk committee is to review the risk management process and maturity of the company, the effectiveness of risk management activities, the key risks facing the company, and the responses to address these key risks.

The focus of the risk committee should broadly be on all current and potential risks that the company faces. Once the key strategic and operational risks have been identified, specific risks may then require particular interventions, either by the risk committee or assigned elsewhere.

For example, the management of operational risks may be assigned to management. A credit management committee may be established to manage counterparty credit risks. Compliance risk may be managed by an appropriate function – for example, legal, compliance or secretariat.

Sustainability risks must also be considered by the risk committee as a part of the overall risk assessment process. However, sustainability performance should be assigned to a dedicated social and ethics committee due to its strategic importance, as it is incorrect to view sustainability solely from a risk perspective.

Therefore, in practice, the sustainability information concerning sustainability risks received by the risk committee would need to be imparted to the social and ethics committee in order for it to fulfil its broader sustainability oversight role. This can be achieved through overlapping membership and/or a process for sharing of information. This interaction is crucial to ensure adequate coverage as well as to minimise duplication.

In addition, some of the outputs of the risk committee would form the platform for the duties of the audit committee, for example:

- the significant risk areas identified will form the subject matter over which combined assurance is obtained;
- The financial reporting risks would need to be fed into the audit committee for assessment of the management and control thereof;
- The audit committee should be informed of all significant actual or potential financial and non-financial risks (such as operational, strategic, regulatory risks) that may have implications on the integrated report.

Social and Ethics Committee

The function of the Social and Ethics committee is to ensure that the performance of the company with regard to social and environmental issues and the integration thereof into strategic and economic performance, is appropriate.

In fulfilling this role the committee could put in place policies, set objectives and monitor integrated sustainability performance.

In relation to the audit committee, the social and ethics committee forms the platform for some of the tasks that the audit committee undertakes, similar to the risk committee. This committee deals with sustainability at the onset, whilst the audit committee should obtain assurance over sustainability disclosure in the integrated report, as well as the internal controls in place to mitigate sustainability risks.

Combined board committees

Having separate audit, risk and social and ethics committees is mandatory for certain entities and is recommended for other entities for reasons set out above.

However, in the case of smaller, non-regulated entities, there may not be the desire or resources to form separate board committees. In such instances, all the functions would need to be appropriately addressed by the board. For example, in the event that there is not a social and ethics committee separate from the risk committee, the board should take responsibility for sustainability considerations that fall outside of risk.

Conclusion

Each of the above committees would need to deal with sustainability and risk matters to a greater or lesser extent and the focus for each is different.

The audit committee should provide assurance on sustainability matters to ensure credible integrated reporting. The risk committee should assist the board to fulfil its role with regard to the identification of sustainability risks. The social and ethics committee should assist the board achieve better performance on sustainability matters.

Just as the existence of a finance and investment committee does not mean that the audit committee should not deal with finance and investment issues from an assurance and reporting perspective. Similarly, an audit committee will deal with risk and sustainability issues from an assurance and reporting perspective notwithstanding the existence of a risk and/or social and ethics committee.

Due to the close correlation and interrelationship of the areas of financial reporting, sustainability reporting and risk, there should be provision for extensive co-operation and liaison between the various committees, for example by having an overlap of at least one member. There should also be a sound understanding of the nature and extent of interdependencies concerning information requirements, and formal structures need to be agreed to meet these requirements.

Effective integration at the board level must be encouraged through regular and effective reporting by all committees to the board.