EFFECTIVE CORPORATE GOVERNANCE -
A SOUTH AFRICAN PERSPECTIVE

Short dissertation

by

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EFFEKTIEWE KORPORATIEWE BESTUUR - 'n SUID-AFRIKAANSE PERSPEKTIEF

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EFFEKTIEWE KORPORATIEWE BESTUUR - 'n SUID-AFRIKAANSE
PERSPEKTIEF

Opsomming

Die bestuur en eienskaps van maatskappye is vir die eerste keer geskei toe die eerste
maatskappye met beperkte aanspreeklikheid gedurende die negentiende eeu in die
Vereenigde State van Amerika and Brittanje gestig is. Professionele bestuurders is
aangestel om die belange van die aandeelhouers as hul agente te behartig.

Hierdie professionele bestuurders is in totale beheer van die bestuursprosesse geplaas
een het gevolglik oor aansienlike mag beskik. Aandeelhouers wou daarteenoor hulself
ten magsmisbruik van die direkteure beskerm. Die "agentskapsprobleem" het
ontwikkel en gevolglik het die beginsels van korporatiewe bestuur ontstaan.

Daar is nog nie 'n algemeen aanvaarde Afrikaanse vertaling vir die term "corporate
governance" nie. Vir die doeleindes van hierdie opsomming word dit vertaal as
"korporatiewe bestuur". In die Suid-Afrikaanse konteks word korporatiewe bestuur
gedefiniëer as die wyse waarop maatskapye geleë en beheer word.

Die doelwitte van hierdie navigation is tweeledig. Die King Report on Corporate
Governance wat korporatiewe bestuur in Suid-Afrika gekodifiseer het, is krities
ondersoek op grond van die kwantitatiewe en kwalitatiewe aspekte van korporatiewe
bestuur om vas te stel of dit noodwendig tot meer effektiewe korporatiewe bestuur in
Suid-Afrika aanleiding sal gee. Verder is navigation ook uitgevoer om 'n
gerusstellingsmeganisme te ontwikkel om aan die gerusstellingsvereistes van
belanghebbendes te voldoen.

Ter inleiding is erkende internationale korporatiewe bestuursmodelle ondersoek.
Verder is korporatiewe bestuur in Suid-Afrika ontleed. Hier is die klem geplaas op die
pligte van direkteure met betrekking tot korporatiewe bestuur en op die proses om
gerusstelling aan die belanghebbendes in 'n maatskapye te verskaf.
Die fidusiêre pligte van direkteure is geïdentifiseer as 'n plig van lojaliteit en 'n plig van sorg en bedrewenheid. Die King Verslag voorsien direkteure met addisionele riglyne oor hul pligte as direkteure met betrekking tot korporatiewe bestuur in 'n Suid-Afrikaanse konteks en bevat spesifieke aanbevelings oor die struktuur en funksionering van 'n direksie.

Die King Verslag is gemeet teenoor die King Komitee se verwysingsraamwerk. Daar is bevind dat die komitee sy doelwitte bevredig het in terme van die kwantitatiewe aspekte van korporatiewe bestuur. Voordat 'n oorkoepelende gevolgtrekking egter oor die effektiwiteit van die King Verslag gemaak kon word, moes die kwalitatiewe aspekte van korporatiewe bestuur ook in ag geneem word.

Daar is bevind dat die King Verslag veral vier kwalitatiewe aspekte van korporatiewe bestuur nie genoegsaam aangespreek het nie. In die eerste plek neem die King Verslag noue fokus op finansiële en rekeningkundige kontroles nie die kritiese besigheidsrisikos in terme van operasionele kontroles en voldoening aan wette en regulasies in ag nie.

Tweedens het die verslag nie die fundamentele vraagstuk van eksterne ouditonafhanlikheid, waar die eksterne ouditfunsie vergoed word deur die liggaam oor wie verslag gedoen word, genoegsaam aangespreek nie.

In die derde plek is vasgestel dat die King Verslag 'n versladoeningsparadigma daargestel het wat tot gevolg het dat korporatiewe bestuur staties word. Daar is bevind dat 'n "beste bestuurspraktyke"-paradigma verlang word om die dinamika van korporatiewe bestuur aan te dryf. Hierdie paradigma is gedefinieer as "implementering van die regte bestuurspraktyke op die regte manier om te verseker dat geen belanghebbende enigsins benadeel word nie".

Vierdens het die King Verslag nie die rol van bestuur om gerustelling aan belanghebbendes te verskaf, behoorlik aangespreek nie.
Effektiewe korporatiewe bestuur

Opsomming

Die gerusstellingsvereistes van aandeelhouers, kontraktuele belanghebbendes en nie-kontraktuele belanghebbendes is geïdentifiseer as hoofsaaklik gerusstelling oor die effektiwiteit van die stelsel van interne beheer om te verseker dat die maatskaapy sal voortbestaan as 'n lopende saak. Hier behoort ouditkomitees 'n belangrike rol te speel om die gerusstellingsproses so te koördineer dat genoegsame vlakke van gerusstelling aan die direksie en uiteindelik aan alle belanghebbendes verskaf word.

KPMG het die Gekombineerde Gerusstellingsmodel ontwikkel wat fokus op gerusstelling oor finansiële en rekeningkundige kontroles. Self-evaluering van kontroles stel egter direkteure in staat om hulle veronderstellings oor die lopende saak beginsel asook oor interne beheer, insluitende operasionele en ander nie-finansiële kontroles, op 'n betroubare wyse te staaf.

Deurdat die bestuur se rol in korporatiewe bestuur as verskaffing van gerusstelling oor kritiese besigheidsrisikos geformaliseer is, is die Veranderlike Gekombineerde Gerusstelling (VGG) Model ontwikkel wat 'n verbetering op die KPMG model is deurdat gerusstelling nie beperk word tot finansiële en rekeningkundige kontroles nie.

Die grondbeginsels van die VGG Model is kortliks as volg:

* Die direksie is verantwoordelik om gerusstelling oor die kritiese besigheidsrisiko's teenoor die belanghebbendes in die jaarverslag uit te spreek.
* Die ouditkomitee koördineer die gerusstelling wat vanaf die bestuur, interne oudit en eksterne oudit verkry word.
* Alhoewel die gerusstelling wat in totaal vanaf hierdie drie bronne verkry word, al die kritiese besigheidsrisiko's van die onderneming aanspreek, sal die vlak van gerusstelling wat aan elke kritiese besigheidsrisiko geheg word wissel na gelang van die bron, of kombinasie van bronne, wat daardie gerusstelling uitspreek.

Die volgende onderwerpe is geïdentifiseer as onderwerpe waarop verdere navorsing uitgevoer behoort te word:

* Die tweeledige raad van direkteure soos vervat in die Duitse model.
* Deelname van werknemers aan die direksie.
EFFEKTIEWE KORPORATIEWE BESTUUR

OPSOMMING

- Tweeledige ouditaanstellings soos vervat in die Japanese model.
- Ouditonafhanklikheid waar die ouditeur vergoed word deur die instansie oor wie verslag gedoen word.
- Opvoeding rondom morele ontwikkeling van bestuurders.
- Kodifisering van beste bestuurspraktyke in 'n soortgelyke wyse as algemeen aanvaarde rekeningkundige praktyk.

Die oorkopeleende gevolgtrekking is dus dat hierdie studie in sy doelwitte geslaag het.
Synopsis

Ownership and management of companies were separated for the first time in the nineteenth century when the first limited liability companies were formed in the USA and Britain. Professional managers, the directors, were employed as agents of a company's shareholders.

As a result, the shareholders wanted to protect their investments against abuse of power by the directors. The agency problem was created and hence, corporate governance was born. The South African definition of corporate governance is "the way in which companies are directed and controlled".

Authoritative corporate governance models were examined and the focus of this research is on the board of directors and the process of providing assurance to stakeholders.

The fiduciary duties of directors were identified as a duty of loyalty and a duty of care and skill. The King Report on Corporate Governance provided additional guidance in respect of directors' duties in the South African context and made specific recommendations on the structure and functioning of boards of directors.

The King Report was measured against the committee's terms of reference and it was concluded that the committee achieved its objectives as regard to the quantitative aspects of corporate governance.

The following four qualitative aspects of corporate governance were identified as not being adequately addressed by the King Report:

1. The narrow focus on internal financial and accounting controls disregarded the critical risks attached to operational controls and compliance with laws and regulations.
2. The report did not adequately resolve the fundamental issue of independence of the external audit function where that function is remunerated by the body on which performance is attested to.

3. The report created a disclosure paradigm that forced corporate governance to become static. A best management practice paradigm was required to propel the dynamics of the corporate governance process. This paradigm was defined as "implementing the right business practices in the right way to ensure that no stakeholder is disadvantaged in any way".

4. The report did not adequately address management's role in providing assurance.

The assurance needs of shareholders, contractual stakeholders and non-contractual stakeholders, were identified as assurance on mainly the effectiveness of the system of internal control to ensure the company's ability to continue as a going concern.

This assurance should be provided by external audit, internal audit and management. All three of these have distinctively different roles in providing the assurance. Audit committees should co-ordinate the nature, extent and focus of the assurance to ensure that sufficient levels of assurance are provided to the board of directors and ultimately to all stakeholders.

KPMG developed a model of combined assurance that focused on financial and accounting controls. Control self-assessment as a management process allows boards of directors to reliably demonstrate their assertions on internal control, including operational and other non-financial controls, and going concern. By formalising management's role in the corporate governance process as providing assurance on critical business risks, this research improved on the KPMG model to create the Variable Combined Assurance Model.
CHAPTER 1: ORIENTATION

1.1 Background

When public funds are invested in a company, a duty of care is created between the directors of the company and the company’s shareholders. The directors are appointed by the shareholders to manage the company on behalf of the shareholders. Therefore, the directors of a company are accountable to the shareholders. The Companies Act, 1973, specifically provides for the directors to report on the business and operations of the company annually as part of the annual financial statements.

Although investors have to acknowledge that any investment has an inevitable risk attached to it, it appears that investors do not have much protection against fraudulent actions by directors. There are many examples of where directors breached their duty of care and almost invariably it was the shareholders of those companies that suffered financial losses. Hence, major corporate collapses around the world put corporate governance under increased scrutiny over the past number of years.

The final report by the National Commission on Fraudulent Reporting under the leadership of James C. Treadway, Jr, was issued in the United States of America during 1987. The Treadway Report, as it has become known, was the first comprehensive report on corporate governance and it resulted in the study entitled “Internal Control - Integrated Framework” by the Committee of Sponsoring Organisations of the Treadway Commission (the COSO Report) that was issued in the USA in 1992.
Many other international studies on corporate governance followed, most notably the “Report on the Financial Aspects of Corporate Governance” under the chairmanship of Sir Adrian Cadbury (the Cadbury Report) that was issued in the United Kingdom in 1992.

South Africa did not escape corporate failures. The failure of Masterbond in 1991 caused a large number of public investors, mostly retired persons, to lose their lives’ savings. This corporate collapse went hand in hand with public outcry as investors regarded themselves as the victims of fraudulent directors and a legal system that offered them almost no protection (McDougall, 1993).

The King Committee was established under the chairmanship of Mervyn King, SC, in 1993 to investigate the implementation of the proposals contained in the Cadbury Report in South Africa. The King Report on Corporate Governance was issued under the auspices of the Institute of Directors, on 29 November 1994. The King Report contains a number of recommendations on corporate governance principles and was issued with a “Code of ethics for enterprises and all who deal with enterprises” and “Affirmative action guidelines”.

1.2 Problem description

Ownership and management of companies were separated for the first time as far back as the nineteenth century when the first limited liability companies were formed in the United States of America and the United Kingdom (King, 1994a:1). Family owned companies started to employ professional managers to manage the affairs on behalf the owners. Therefore professional managers act as agents of the owners of a company.
These professional managers, the directors, were entrusted with total management power. As a result, the owners wanted to protect their investments against abuse of power by the directors. The "agency problem" was created and hence, corporate governance was born.

Although the agency problem focused primarily on the relationship between the owners of a company and their agents (the directors), corporate governance adds a further dimension by also addressing the relationship between a company and its stakeholders, such as employees, regulators, financiers and the environment.

A number of corporate governance models have been created over the past century. Corporate governance in South Africa followed the corporate governance trends of mainly the United Kingdom. Although the recommendations of the King Report may improve corporate governance in South Africa, it can be argued that an effective system of corporate governance in South Africa should adequately resolve both the quantitative and qualitative aspects of corporate governance.

1.3 Objective of the research

The Cadbury Report focused on the financial aspects of corporate governance. The terms of reference of the King Committee not only included the financial aspects of corporate governance but it also included a Code of ethical practice for South African business enterprises.

In addition, the King Report had to take into account the emergence of members of the communities that were disadvantaged by the Apartheid era, as a new class of entrepreneur in South Africa.
The two main objectives of this short dissertation were formulated as evaluating the King Report on Corporate Governance to establish whether or not the recommendations of the report would necessarily lead to more effective corporate governance in South Africa and to investigate and/or formulate a model to improve the quality of assurance provided to stakeholders.

1.4 Scope, limitations and exclusions

This research briefly examined the corporate governance models of the United Kingdom, Germany and Japan as these three models are most often applied in industrialised countries. A fourth model, the Anglo-American model, as referred to by King (1994a:1) is mostly in line with the classic UK model and for the purposes of this short dissertation, the two will be regarded as synonymous.

In addition, this research examined the appropriateness of the recommendations of the King Committee, identified areas that were not adequately addressed by the King Report and considered whether or not the King Report will lead to effective corporate governance in South Africa.

Although affirmative action is a South African business reality, it is regarded as a socio-political issue and therefore it was excluded from this research.

The concepts of effective internal control and an enterprise’s ability to continue to operate as a going concern are fundamental to effective corporate governance. These two concepts were addressed in this study. However, it was not the intention of this study to conduct specific research on internal control and going concern.
This short dissertation focused primarily on the roles of the board of directors and the providers of assurance to stakeholders as elements of an effective system of corporate governance.

1.5 Research methodology

A literature study of existing authoritative literature on corporate governance was performed. Corporate governance models were examined and the recommendations of the King Report that dealt with the board of directors and the audit function were considered with regard to adequacy and/or appropriateness.

The information that was gathered was used to consider whether or not the King Report will lead to more effective corporate governance in South Africa.

1.6 Framework of the study

In order to achieve the objectives of the research, the study was conducted within the following framework:

- Chapter 1: The background to the agency problem and the objectives of the research are identified.

- Chapter 2: The literature study is introduced and the concept of corporate governance is explored further. The corporate governance models of the United Kingdom, Germany and Japan are examined.
• Chapter 3: Directors' duties relating to corporate governance and the role of the board of directors in corporate governance is analysed.

• Chapter 4: Assurance to stakeholders is considered. The role of internal and external audit and management in corporate governance is analysed. In addition, the role of audit committees as facilitator of the assurance process is also explored.

• Chapter 5: The King Report is analysed to identify inadequacies. This information is used to determine whether or not the King Report will lead to effective corporate governance in South Africa.

• Chapter 6: The research findings and opportunities for further research are presented.

1.7 Summary of research findings

In chapter 1 the classic UK (before and after the Cadbury Report), German and Japanese corporate governance models were examined. The South African corporate governance framework, as codified by the King Report which fundamentally based the South African framework on the Cadbury model, was also examined.

Chapter 2 recognised that a corporate governance framework consists of two principal elements that were dealt with separately in the two subsequent chapters:
1. The board of directors (chapter 3).
2. Providing assurance to stakeholders (chapter 4):
Chapter 3 identified the fiduciary duties of directors as a duty of loyalty and a duty of care and skill. The King Report provides additional guidance in respect of directors' duties and makes specific recommendations on the structure and functioning of the board of directors.

It was established in Chapter 3 that the duties and responsibilities of non-executive directors did not differ from those of executive directors. Non-executive directors are appointed to bring independence into board deliberations in order to improve the overall effectiveness of the board.

As identified in chapter 4, the three classes of stakeholders, being shareholders, contractual stakeholders and non-contractual stakeholders, have specific needs as regards to assurance being provided to them. However, the common thread in this assurance needs is assurance on the effectiveness of the system of internal control to ensure the company's ability to continue as a going concern.

Three main sources of assurance providers were identified as being the external audit function, the internal audit function and management. All three of these assurance providers have a distinctively different role in corporate governance and providing assurance to stakeholders.

Audit committees have an important role in co-ordinating the nature, extent and focus of the assurance provided by the three assurance providers to ensure that sufficient levels of assurance is provided to the board of directors and ultimately to all stakeholders.

Assurance on financial and accounting controls are provided by all three of the assurance providers. To this end, KPMG has developed a model of combined assurance. The KPMG model's focus is on financial and accounting controls and it does not address the issue of internal control beyond financial and
accounting controls. This narrow focus is therefore regarded as a weakness and improvements to the model were considered in chapter 5.

Chapter 5 measured the report by the King Committee against the committee's terms of reference and it was concluded that the committee achieved its objectives as regard to the quantitative aspects of corporate governance. However, a true corporate governance model should adequately address the qualitative aspects of corporate governance.

Four qualitative aspects of corporate governance were identified in chapter 5 as not being adequately addressed by the King Committee. Firstly the narrow focus on internal financial and accounting controls disregards the critical risks attached to operational controls and compliance with laws and regulations.

Secondly, the report does not adequately resolve the fundamental issue of independence of the external audit function where that function is remunerated by the body on which performance is attested to.

Thirdly, the King Report has created a disclosure paradigm which forces corporate governance to become static. A best management practice paradigm is required to propel the dynamics of the corporate governance process.

In the fourth place, the King Report does not adequately address management's role in providing assurance. Control self-assessment as a management process will allow boards of directors to reliably demonstrate their assertions on internal control and going concern.

By formalising management's role in the corporate governance process to provide assurance on critical business risks in chapter 5, this research improved
on the KPMG Combined Assurance Model and created the Variable Combined Assurance Model.

1.8 Conclusion and opportunities for further research

It was established in chapter 2 that the principle of a two-tiered board of directors, as embodied in the German model, could be appropriate in the South African business environment. It was recommended that this issue becomes the topic of further research.

The King Report was not endorsed by labour representatives due to the report’s lack of recognising worker participation at board level. Therefore it was recommended that this issue becomes the topic of further research.

The concept of two audit appointments per the Japanese corporate governance model, as dealt with in chapter 2, should form the topic of further research as it may serve to strengthen and define more clearly the roles of internal and external auditors in the South African corporate governance context.

It may be argued that, as long as the principle of being paid by the persons on who’s performance is attested to, is not properly addressed, true external audit independence will not be adequately resolved. Therefore it was recommended that this issue forms the topic of further research.

Baxter and Rarick (1987:243) proposed the concept of education for the moral development of managers. Although many questions may be asked around this proposal, its application in the South African context should be subject of further research.
Chapter 5 identified the need to research best management practice and to codify the resulting benchmarks in a similar way as generally accepted accounting practice and generally accepted auditing standards.

The King Report was evaluated in terms of quantitative and qualitative aspects. It was concluded that the report achieved its objectives in terms of quantitative aspects. However, the King Report did not adequately address the qualitative aspects of corporate governance in four main areas. This had an adverse effect on the overall quality of the report and therefore it was concluded that the King Report on Corporate Governance may not necessarily lead to more effective corporate governance in South Africa.

The Variable Combined Assurance Model was developed in this short dissertation. This model will provide stakeholders with variable levels of assurance on all aspects of organisational performance. It is an improvement on the KPMG Combined Assurance Model that provides assurance to stakeholders on financial and accounting controls.

It was therefore concluded that this short dissertation achieved its objectives.
CHAPTER 2: THE THEORY OF CORPORATE GOVERNANCE

2.1 Introduction and research methodology

The results of the literature study that was carried out are reflected in chapters 2 to 4.

Chapter 2 addresses the theory of corporate governance and consists of an examination of the corporate governance models of the UK (before and after the Cadbury Report), Germany and Japan. The “Anglo-American” model is mostly in line with the UK model, therefore it was excluded from this study.

2.2 The concept of corporate governance

The Cadbury Report (1992:15) and the King Report (1994:1) defined corporate governance as “the system by which companies are directed and controlled”.

Therefore, the corporate governance process has the following four principal activities as identified by Tricker (1984:7):

1. Direction:
   Formulating the long term strategic direction of the company and ensuring that the identified strategic plan is implemented and monitored on an ongoing basis.

2. Executive action:
   Making decisions that are crucial to the well being of the company and that may have a major impact on the company and/or its business.
3. Accountability:
   Being accountable to legitimate stakeholders for the actions of the company.

4. Supervision:
   Oversight, monitoring and evaluation of management performance.

Although the direction and executive action activities are mainly management functions, as opposed to supervision and accountability activities being mainly governance functions, these four principal activities are interrelated.

There are three principal corporate governance-models:
1. United Kingdom model
2. German model
3. Japanese model

Corporate Governance in South Africa is based on the UK model. However, to put this model into perspective, one needs to understand the principal differences between the three.

2.3 The classic UK corporate governance model

The classic UK model is enshrined in UK corporate law. An illustration of the classic UK model is presented in Figure 2.1. Macdonald and Beattie (1993:305) pointed out the following underlying concepts of the classic UK model:
1. The company is a separate legal entity.
2. The owners have the power to govern the company.
3. Transferability of shares causes the company to exist into perpetuity.
4. The board of directors oversees the management of the company and reports to the owners on a regular basis.

5. The owners appoint independent auditors to report as to whether or not the annual financial statements are a true and fair view of the company’s affairs.

The South African Companies Act, 1973, is largely based on the UK Companies Act and therefore all of the above principles are applicable in South Africa. Apart from the statutory duties of directors, for example to ensure that proper accounting and other records are kept, directors may arrange amongst themselves on how a company should be managed.

Figure 2.1: The classic United Kingdom corporate governance model
The Cadbury Report (1992:54-60) recommended specific changes to the classic UK model to ensure greater accountability to shareholders and other stakeholders. The main differences between the Cadbury model, as illustrated in Figure 2.2, and the classic UK model are as follows:

1. The chairman of the board of directors should be non-executive.
2. An audit committee, chaired by a non-executive director and consisting of a majority of non-executive directors, should be established to oversee the audit process.
3. The directors should include, in the annual report, a report on the effectiveness of internal control during the year under review. The auditors should state that they concur with the directors' statement.
4. The directors should include, in the annual report, a statement that the entity is a going concern. The auditors should state that they concur with the directors' statement.

Figure 2.2: The Cadbury model of corporate governance
The King Report endorsed most of the Cadbury recommendations and therefore it is concluded that the South African corporate governance framework is based on the Cadbury model, even though the King Code of Corporate Practices and Conduct (IOD, 1994b) is still in the process of being implemented in South Africa.

The King Report did, however, back-track on some of the Cadbury recommendations, which weakened the South African corporate governance framework to some extent. This matter is addressed in detail in chapter 5.

2.4 The German corporate governance model

The German model is based on a two-tiered board of directors as illustrated in Figure 2.3. The supervisory board is responsible for the supervision and accountability actions and has no executive management powers. The supervisory board has the authority to appoint, approve and/or remove the management board to discharge its supervisory responsibilities. The shareholders and employees elect the members of the supervisory board in order to make the supervisory board representative to fulfil its accountability role.

The management board, on the other hand, is responsible for the direction and executive action activities, including the day-to-day management of the company’s affairs. Although the supervisory board does not participate in the executive management of the company, the management board has to report regularly to the supervisory board on strategic, financial and operational matters.
The German model was developed mainly as a result of the following:

1. A revolutionary situation existed in Germany after World War I and supervisory boards were first set up, as a result of pressure from the strong labour unions, to recognise workers' rights.

2. German capital markets were structured in such a way that companies obtain equity funding from banks, as opposed to public subscriptions. Therefore, German banks have traditionally appointed representatives to the supervisory boards of companies to which significant loans have been made, to monitor the stewardship of their investments.

Figure 2.3: The German corporate governance model

With the large institutional investors present in the South African capital markets and the strength of organised labour, the concept of a supervisory board should not be ignored in South Africa. The King Committee considered
the appropriateness of a two-tier board for South Africa. It concluded, however, that "every objective of the two-tier structure can also be attained in a unitary structure" (1994a:6).

The King Committee Report was not endorsed by labour representatives due to the report's lack of recognising worker participation at board level. It therefore appears that the unitary board structure as recommended by King (1994a:26) does not adequately address worker participation. Therefore it is recommended that this issue becomes the topic of further research.

2.5 The Japanese corporate governance model

Although the Japanese model with its single tier board, as illustrated in Figure 2.4, seems to be very similar to the classic UK model, an analysis by Cooke and Kikuya (1992:36) concluded that the Japanese model is, in fact, more closely aligned to the German Model due to the substantial influence of banks on large corporations.

As is the case in Germany, banks are the major source of funding and have therefore become involved in the major investment decisions of the companies to which funds are made available. As a result of this involvement, the Japanese banks have a substantial influence on corporate governance.

The main difference between the Japanese and the German models is that, in Japan the banks have a substantial influence on corporate governance as a result of being a major financier. In Germany, on the other hand, the banks have a substantial influence on corporate governance as a result of being major shareholders.
In practical terms, the Japanese model is concentrated around a very powerful board chair and executive committee with very little shareholder participation. Mcdonald and Beattie (1993: 306) reported that a study by Mochizuki in 1992 concluded that the Japanese model resulted in a lack of corporate governance in Japan.

Figure 2.4: The Japanese corporate governance model

It was interesting to note, however, that a two-tier system of corporate reporting exists in Japan. As a result, two audit appointments were made:

1. Statutory auditor:

   It is the duty of the statutory auditor to audit and report on the financial statements and the operations of the company, including assessing the performance of the directors in discharging their duties, and to identify fraud and/or illegal acts. The main purpose of the statutory audit is to create a degree of protection for current investors and creditors.
2. Independent accountant auditor:

It is the duty of the independent accountant auditor to report on the financial statements. The aim of the independent audit is to create a degree of protection for general investors, including potential future investors.

Given the cultural differences between Western and Eastern business communities, it is unlikely that the Japanese model could be implemented successfully in South Africa. The concept of two audit appointments could be investigated as it may serve to strengthen and define more clearly the roles of internal and external auditors in the South African corporate governance context.

2.6 Conclusion

In this chapter the classic UK (before and after the Cadbury Report), German and Japanese corporate governance models were examined. The South African corporate governance framework, as codified by the King Report which fundamentally based the South African framework on the Cadbury model, was also examined.

It was further established that the principle of a two-tier board, as embodied in the German model, could be appropriate in the South African business environment. It is recommended that this issue becomes the topic of further research.

A corporate governance framework consists of two principal elements that were dealt with separately in the following two chapters:

1. The board of directors (chapter 3).
2. Providing assurance to stakeholders (chapter 4):

The mechanisms that provide assurance on:

- financial reporting to stakeholders and users of financial statements,
- activities of the board of directors and management,
- the effectiveness of the internal control, and
- going concern.
CHAPTER 3: THE BOARD OF DIRECTORS

3.1 Introduction, research methodology and exclusions

Chapter 3 formed part of the literature study as described in chapter 2. This chapter addressed the King Report recommendations affecting boards of directors, the fiduciary duties and responsibilities of directors and the specific role of non-executive directors.

The statutory duties of directors under the Companies Act, 1973 were specifically excluded as these duties were specific and pre-determined by legislation. The concept of corporate governance was focused on fiduciary duties as opposed to statutory duties and therefore it was not appropriate that this research dealt with the statutory duties of directors.

3.2 The King Report recommendations on the structure and operation of boards of directors

This section summarised the King Report recommendations affecting the structure and operation of boards of directors. The King Report recommendations that addressed directors' duties were dealt with under section 3.3.

3.2.1 The Chair

The chair should be a non-executive director and should not be the same person as the chief executive (King, 1994a:26)
When the board considers that it is not in the company’s interest that the roles of the chair and chief executive is separated, it is permitted that these roles be fulfilled by the same person. In such cases the non-executives should ensure that the chair "encourages proper deliberation of all matters requiring the board’s attention and obtains optimum input from the other executive directors" (King, 1994a:32).

3.2.2 Board Structure

A unitary board structure should be adopted and should have a balance of executive and non-executive directors (King, 1994a:26).

3.2.3 Non-Executive Directors

Although King recognised the possible shortage of skilled non-executive directors in South Africa, it recommended that boards should have at least two non-executive directors of "sufficient calibre" (1994a:27).

The King Code also stated that non-executive directors should "bring an independent judgement to bear" and went further to recommend that non-executive directors who do not contribute to board decisions should "not be re-elected or should have their services terminated" (1994a:32).

3.2.4 Board meetings

King recommended that individual boards should determine how often they should meet to ensure that they function properly (1994a:27).
However, King required that boards should meet at least on a quarterly basis (1994a:27).

### 3.2.5 Worker participation

King recommended that worker should participate in the governance of the affected corporations (1994a:27). However, it was left to the individual corporations to evolve their own systems of worker participation in corporate governance (1994a:7).

### 3.2.6 Company Secretary and Professional advice

Affected corporations should employ competent company secretaries or contract company secretarial services to professional organisations. The main role of the secretarial function should be to ensure compliance with the King Code and relevant legislation (King, 1994a: 27).

The board should also be entitled to seek professional advice outside the corporation at the corporation's expense (King, 1994a: 27).

### 3.2.7 Directors dealing in shares of a listed company

When directors of listed companies sell, buy or take positions in shares of the companies of which they are directors, they should notify the company secretary of their intentions and record all details of such transactions in writing with the company secretary. Such details should be tabled at the following board meeting (King, 1994a: 27).
A closed period for dealings in such shares prior to announcements of financial results should also be considered (King, 1994: 27).

3.2.8 Board appointments

King recommended that the selection of directors should be "planned, agreed and managed" by the board and should not contain elements of tokenism or cronyism (1994a:29).

If new appointees did not have previous board experience they should participate in training programmes for directors. New appointees should also go through a period of induction to become familiar with a corporation's business, resources, systems and management structures (1994a:29).

3.2.9 Service contracts for executive directors

Service contracts for executive directors should not exceed five years and extensions should be approved by the shareholders (King, 1994a:29).

3.2.10 Directors' remuneration

King recommended that directors' remuneration should be disclosed in total, separate executive and non-executive directors' remuneration and contain a breakdown of the categories of remuneration such as fees, salaries, share options, bonuses and other benefits (1994a:29).
3.2.11 Remuneration committees

Remuneration committees should be appointed to recommend directors' remuneration packages. Remuneration committees should be chaired by non-executive directors (King, 1994a:29).

3.3 Directors' duties and responsibilities

The purpose of this section was to summarise directors' duties and responsibilities. It incorporated the recommendations of the King Report.

3.3.1 Fiduciary duties and responsibilities

The common law requires that directors act in good faith (a duty of loyalty) and that directors should act with due care and skill.

3.3.1.1 Duty of loyalty:

When persons accept appointments as directors, they commit themselves to the organisation of which they are directors. They should therefore acknowledge that the best interests of the organisation prevail over their personal interests (Deloitte & Touche, 1995:13).

The duty of loyalty therefore requires that directors should not place themselves in positions where their duty of loyalty is in conflict with personal interests.
Therefore, where an opportunity presents itself, and is within the scope of a company's objectives and activities, directors should seek to obtain any benefits for the company and not for themselves (KPMG, 1995:29).

Directors are exposed to detail information about the company's affairs that are not known to the general public. Such information should be treated as confidential. Any personal gains made by directors as a result of having access to confidential information are in breach of the duty of loyalty and are reclaimable from such directors (KPMG, 1995: 30).

Directors are also obliged to be attentive to company affairs by attending all meetings and by familiarising themselves with available information to make informed decisions.

3.3.1.2 Duty of care and skill:

The duty of care and skill may be explained as follows:

"A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, ... with such care as an ordinarily prudent person in a like position would use under similar circumstances" (Deloitte & Touche, 1995:14).

Therefore directors need not to display a higher level of skill that may be reasonably expected of persons with their knowledge and experience (KPMG, 1995:28).
3.3.2 The guidance and recommendations of the King Report

The King Report provided additional guidance in respect of directors' duties and responsibilities in chapter 5 of the report. The guidance can be summarised as follows (1994a: 8-9):

3.3.2.1 Directors should ensure that they have the time to devote to carry out properly their duties and responsibilities to the company.

3.3.2.2 Directors should be informed about the financial, social and political milieu in which the company operates.

3.3.2.3 Directors must be satisfied that they are in a position to make informed decisions.

3.3.2.4 Directors must disclose potential conflict of interest at the earliest opportunity.

3.3.2.5 Directors must act independently from outside fetter or instruction.

3.3.2.6 Directors must act with enterprise and always strive to increase shareholders' value while having regard for the interests of all stakeholders.

3.3.2.7 Directors must ensure that all interested parties are fully informed of any material matter affecting the company's business with openness and substance over form being their guideline.

3.3.2.8 Directors must exercise the utmost of good faith, honesty and integrity in all their dealings with or on behalf of the company.

3.3.2.9 Directors must ensure that the company's strategy and structure has been collectively agreed by the board.
3.3.2.10 Directors must insist that board papers and information are given to them timeously so that they have time to study them and make properly informed decisions.

3.3.2.11 Directors must ensure that the company prepares annual budgets against which the company's performance can be monitored.

3.3.2.12 Directors must ensure that procedures and systems are in place to act as checks and balances on the information being received by the board.

3.3.2.13 Directors must ensure that the board monitors the performance of executive management against budgets, business plans, industry norms, prior years' performance etc.

3.3.2.14 Directors must ensure that the company has an affirmative action plan in place to advance members of disadvantaged communities in the business of the company as in most cases it will be necessary for the long term survival of the company.

In addition to the above guidance, the King Report also recommended that the directors' report should incorporate statements on the following (1944a: 9-10):

3.3.2.15 The financial statements are the responsibility of the directors.

3.3.2.16 The auditor is responsible for reporting on the financial statements.

3.3.2.17 The financial statements fairly present the state of affairs of the company.

3.3.2.18 Adequate financial records have been maintained.
Suitable accounting policies, consistently applied and supported by reasonable prudent judgements and estimates, have been used in the preparation of the financial statements.

Applicable accounting standards have been applied, but if there has been any departure in the interests of fair presentation it must be disclosed and maintained.

An effective system of internal control has been maintained.

If the directors are in any doubt about the ability of the company to continue as a going concern in the year ahead this should be so stated.

King stated clearly that the board should retain full and effective control over the company (1994a:27). Therefore the directors were ultimately responsible for implementing and maintaining the system of internal control both operational and financial (1994a:5).

However, it is regrettable that, in its recommendations, the King Committee recommended that the directors' statement on internal control includes only financial controls (1994a:20), therefore excluding operational controls.

It is further regrettable that the King Code on corporate practices and conduct was watered-down even further by not indicating where the directors' statement on internal control should be disclosed in the annual report (1994a:34) as the listings requirements of the Johannesburg Stock Exchange require disclosure on the extent of compliance with the Code and not the recommendations.
King also recommended that directors should not be held liable for a breach of the duty of care and skill if they exercised a business judgement in good faith in a matter in which all of the following criteria applies (1944a: 9):

3.3.2.23 That the decision was an informed one based on all the facts of the case.
3.3.2.24 That the decision was a rational one.
3.3.2.25 That the director had no self-interest in the matter.

Chapter 5 of the King Report concluded that the directors had to ensure that the business remains a going concern, i.e. that it survives. "In short, directors' duties in relation to their companies are to drive, strive, survive and thrive" (1994a:10).

3.4 The role of non-executive directors

This section addressed the role of non-executive directors in corporate governance. It explored the main reasons for appointing non-executive directors. In addition it examined the duties of non-executive directors, particularly in the light of the recommendations of the King Report.

3.4.1 The reasons for appointing non-executive directors

Non-executive directors are not employees of a company and are usually appointed on a part time basis. Therefore the main reason for appointing non-executive directors is to bring independence into the board process.
This independence can contribute as follows (Coopers & Lybrand, 1994:15):

- Brings wider general or special experience into board deliberations.
- Monitors management performance against forecasts and approved strategic plans.
- Ensures adequate safeguards of company interests in cases where these may conflict with the personal interests of directors.
- Ensures the adequacy of financial and other information available to the board.

3.4.2 The duties of non-executive directors

The Companies Act, 1973 did not distinguish between executive and non-executive directors. Therefore the statutory duties of all directors, whether they are executive or non-executive directors, were the same.

Hence, non-executive directors were expected to show the same care and fiduciary duties to a company as an executive director (refer section 3.3 above). Non-executive directors were also subject to the same liability as any other director for loss arising from breaches of duties. Therefore non-executive directors should ensure that they had the same access to company information as the other directors and that they had the time to properly discharge their duties as directors. (Coopers & Lybrand, 1994:15).

3.4.3 The guidance and recommendations of the King Report

The King Report provided additional guidance and specific recommendations on non-executive directors in chapters 6 and 19 of
the report. The guidance and recommendations can be summarised as follows:

3.4.3.1 Non-executive directors should be independent in the sense that they are independent of management and do not have any benefits from the company other than their fees. The intention is not to exclude persons who have a contractual nexus with the company for reward or to prevent non-executive directors from acquiring shares in the company by means independent from the company (1994a:28).

3.4.3.2 King suggested that the following persons would normally be suitable candidates for non-executive appointments:

- Directors or managers of the company's holding company, or major investor, who has no executive responsibilities in the company.
- Former executive directors who are no longer employed on a full time basis but nevertheless are capable of giving valuable input to the board arising from past experience.
- Senior executive directors of major listed subsidiaries and associates of the holding company, who has no executive responsibility in the holding company.

(1994a:28)

3.4.3.3 The terms served by non-executive directors should be determined by the board and it should be the duty of the chair to ensure that non-executive who do not contribute to board deliberations should not be re-elected as non-executive directors, asked to resign or even be removed from the board.

(King, 1994a:28)
3.4.3.4 Companies should encourage their executive directors to take non-executive appointments in other companies. This will increase the pool of non-executive directors and will also broaden the skills base of executive management. (King, 1994a:12)

3.5 Conclusion

This chapter identified the fiduciary duties of directors as a duty of loyalty and a duty of care and skill. Directors should always act in the best interest of the company and should display the level of skill that may be reasonably expected from persons with their knowledge and experience.

The King Report provided additional guidance in respect of directors' duties and made specific recommendations on the structure and functioning of the board of directors. The main purpose of the guidance and recommendations were to ensure that directors were aware of their fiduciary duties and to ensure that boards of directors functioned more effectively.

The duties and responsibilities of non-executive directors do not differ from those of executive directors. The concept of non-executive directors was introduced to bring independence into board deliberations in order to improve the overall effectiveness of the board.
CHAPTER 4: ASSURANCE TO STAKEHOLDERS

4.1 Introduction, research methodology, definitions and exclusions

Chapter 4 formed part of the literature study as described in chapter 2. This chapter addressed the concept of assurance on the state of the company's affairs being provided to the stakeholders of the company.

This chapter focused on the three main "assurance providers" being external audit, internal audit and management. This chapter also considered the recommendations of the King Report that effected the above parties.

In addition, this chapter examined the role and responsibilities of audit committees in corporate governance. The chapter also explored the concept of combining the assurance provided by external audit, internal audit and management to stakeholders.

For the purpose of this short dissertation, stakeholders, external audit, internal audit and management were defined as follows:

4.1.1 Stakeholders

The King Report defined stakeholders as "any person, entity or interest group that has some association with the company. There are three classes of stakeholders: shareholders, parties who contract with the company and parties who have a non-contractual nexus with the company. An example of a contacting party is the employee and a non-contracting party is the State" (1994a:16).
4.1.2 External audit

Auditing Exposure Draft 100 (SAICA, 1994:2) entitled Glossary of Terms described external audit as follows:

"The objective of an audit of financial statements is to enable an auditor to express an opinion as to whether or not the financial statements fairly present, in all material respects, the financial position of the entity at a specific date, and the results of its operations and cash flow information for the period ended on that date, in accordance with an identified financial reporting framework and/or statutory requirements".

The above definition was in line with the definition used in the glossary of terms of the International Standards on Auditing issued by the International Federation of Accountants (IFAC, 1994:40).

4.1.3 Internal Audit

The Institute of Internal Auditors defined internal auditing as "an independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation" (IIA, 1978:iii).

4.1.4 Management

Management was defined in ED100 as follows:

"Management comprises officers and others who also performs senior managerial functions" (SAICA, 1994:10).
4.2 Stakeholders and their need for assurance

The three categories of stakeholders that were defined above, had specific needs for assurance on the well being of a company as a whole. However, the document entitled "Internal Control - Integrated Framework" (the COSO Report) established the principle that only reasonable assurance, and not absolute assurance, could be provided to stakeholders (COSO, 1992:4). This principle was re-affirmed in the Canadian "Guidance on Control" document (CICA, 1995:3)

The assurance needs of the three categories of stakeholders were described by the King Report as follows:

4.2.1 Shareholders

The term "shareholders" for the purpose of this short dissertation included current and potential investors.

Shareholders required assurance that the capital they invested was preserved, therefore more specifically, that the company would continue to operate as a going concern (King, 1994a:16).

Shareholders also wanted assurance that their investments would achieve maximum capital growth and would yield the required return on investment. Shareholders were therefore looking to companies for providing them with assurance on fair presentation in the financial statements and on the effectiveness on the system of internal control. Hence, the directors of a company needed to ensure that the company survived and thrived as a going concern. (King, 1994a:16).
4.2.2 Contractual stakeholders

Contractual stakeholders included all parties that had contractual relationships with a company, for example, employees, suppliers, customers and financiers.

These stakeholders wanted assurance that the company would continue as a going concern, thereby ensuring that contractual obligations would be fulfilled. For example, employment would be secured, suppliers would be paid and customers would be served (King, 1994a:16).

4.2.3 Non-contractual stakeholders

Non-contractual stakeholders included the State, regulators, natural resources (the environment) and the socio-economical communities that may directly or indirectly be effected by the business operations of a company.

These stakeholders also wanted assurance that the company would continue to operate as a going concern, for example, taxes were paid, pollution was controlled and social responsibility programmes were introduced (King, 1994a:16).

4.3 The role of external audit

The role of external audit was examined under the inherent limitations of an audit, the role in providing assurance to stakeholders, audit independence and the role in corporate governance.
4.3.1 The inherent limitations of an external audit

First and foremost, stakeholders should appreciate the inherent limitations of an external audit. In line with the COSO principle as highlighted above, an external audit could only provide reasonable, and not absolute, assurance that the financial statements were free of material misstatements.

The auditing statement AU005 on the external auditor's responsibility to detect and report illegal acts, other irregularities and errors (SAICA, 1992:3) provided the following reasons for the above:

4.3.1.1 An external audit was subject to the inherent limitations of the system of internal control.

4.3.1.2 An external audit was subject to the inherent limitations of selective testing (sampling).

4.3.1.3 The nature of audit evidence was persuasive rather than conclusive.

4.3.2 The role of external audit in providing assurance

From the definition of an external audit it was clear that the external auditor had a duty to report on fair presentation in the annual financial statements. Therefore, stakeholders were looking towards external auditors, as an independent external party, for providing reasonable assurance that the annual financial statements were free from material errors and misstatements.
An external audit opinion was limited to the financial statements. The external auditor would therefore only consider those elements of the internal control system that had a direct impact on the financial statements.

However, auditing statement AU005 (SAICA, 1992:05) required external auditors to plan their audit procedures in such a way that there was a reasonable expectation that material misstatements would be detected.

### 4.3.3 External audit independence

The King Report stated that the proper functioning of the external audit function was absolutely dependent on the complete independence of external auditors (1994a:19).

The King Report also pointed out that whilst external auditors had to work with management, they had to do so objectively and consciously aware of their accountability to shareholders (1994a:19).

The King Report proposed that an audit committee, chaired by a non-executive director, should be established to maintain the objectivity between the external auditors and management (1994a:19).

Differences of opinion between the external auditors and management could be aired, discussed and agreed upon in the audit committee. In addition, the external auditors should be able to turn to the non-executive directors in regard to any concerns they have about the company or its business (King, 1994a:19).
External auditors were also warned in the King report that the provision of non-audit services should not lead to impairing the external auditors' effectiveness in performing the external audit function (1994a:19). Therefore the King Report recommended that the audit committee should establish the quantum of the audit fees.

It was not the intention of this short dissertation to address the problems relating to external auditors' independence, however, it may be argued that, as long as the principle of being paid by the persons on who's performance was attested to, was not properly addressed, this matter would not be adequately resolved. Therefore it was recommended that this issue formed the topic of further research.

4.3.4 The role of external audit in corporate governance

The external audit provided an independent and objective opinion on the way in which the annual financial statements were prepared and presented. It was therefore one of the cornerstones of corporate governance (King, 1994a:18).

In addition to the statutory audit obligations, the King Report required external auditors to concur with the proposed management statements on internal control (1994a:20) and going concern (1994a:21) and to express limited assurance on interim financial information by way of an audit review (1994a:21), in order to address the assurance needs of stakeholders.
Apart from the costs involved in providing the above assurance, there were some fundamental issues relating to internal control that was not adequately addressed in the King Report. These issues were dealt with in detail in chapter 5.

4.4 The role of internal audit

The objective of internal auditing was to assist members of the organisation, including management and the board of directors, in the effective discharge of their responsibilities. Therefore internal auditing furnished them with analyses, appraisals, recommendations, counsel and information regarding the activities reviewed (IIA, 1978:iii).

Internal audit was an appraisal function, therefore it was not internal audit's responsibility to establish or maintain the internal control system. However, it was established that internal audit had a valuable role to evaluate the effectiveness of the internal control system and to recommend improvements to the internal control system (KPMG, 1995:25).

Internal auditors owed a responsibility to both management and the board of directors and should provide them with information about the adequacy and effectiveness of the internal control system (IIA, 1978:iii) and the quality of performance (King, 1994a:22).

The King Report recommended that affected corporations should have effective internal audit functions that had the respect and co-operation of both the board of directors and management (1994a:34).
The King Report also recommended that the scope of internal auditing should include the following (1994a:22):

4.4.1 Review the reliability and integrity of financial and operating information and the means used to identify, measure, classify and report such information.

4.4.2 Review the systems established to ensure compliance with those policies, plans, procedures, laws and regulations which could have a significant impact on operations and reports.

4.4.3 Review the means of safeguarding assets and, where appropriate, verify the existence of such assets.

4.4.4 Appraise the economic and efficient management of the company's financial, human and other resources and the effective conduct of its operations.

4.4.5 Review operations or programmes to ascertain whether or not results are consistent with established objectives and goals and whether or not the operations are being carried out as planned.

Due to the stakeholders' needs for assurance that the system of internal control was sufficient to ensure the survival of the company, internal audit formed an important part of corporate governance and was one of the mechanisms for necessary checks and balances in a company (King, 1994a:21).

### 4.5 The role of management

Apart from making specific recommendations on the structure and operation of the board of directors, the King Report dealt with management's role in corporate governance in mainly two areas, firstly ethics and secondly internal control and going concern.
4.5.1 Ethics

Most transactions concluded by companies involved mutual rights and obligations. This involved trust and the responsibility of management that the company should do business in the highest ethical manner (King, 1994a:24).

In essence, corporate governance was based on enterprise and integrity. The fiduciary duties of directors were most important. In addition, the responsibility to act in good faith in the interest of the company should be extended beyond the board of directors throughout the business and to all stakeholders (King, 1994a:24).

However, it was the responsibility of the directors to determine the moral and ethical climate of the business. This could be done by publishing policy statements and conduct guidelines and ensuring that they were acted upon (King, 1994a:24).

The King Report also included a "Code of ethics for enterprises and all who deal with enterprises". The purpose of the code was defined as follows (King, 1994c:2):

"Identifying human needs, and responding by producing goods and services, is a worthwhile activity deserving of material reward. Working in business is ethical in that it gives opportunities to men and women to use their unique qualities and skills creatively in the positive development of society.

The way in which business conducts itself should be as ethical as its contribution to society. Business behaviour should be measured by standards comparable to those applied to any individual."
The ethical standards of business enterprise should reflect the values of the new South Africa and its diverse society.

The code is intended for use to raise ethical awareness, and as a guide in day-to-day decisions. It contains aspirational ethical guidelines for everyday events that occur in business. It can also be used in training programmes, and to help assure customers, suppliers and competitors of the business enterprise with which they deal. Reference to a document containing a code of ethics should not, of course, replace reliance on ethical values that form part of the human character".

Baxter and Rarick (1987:243) concluded that giant corporations had cast moral shadows over much of the world. They proposed the concept of education for the moral development of managers.

Although many questions may be asked around this proposal, its application in the South African context should be subject of further research.

It was not within the scope of this short dissertation to conduct detail research on ethics, however, it should be emphasised that boards of directors had to create a culture in the South African business world where any stakeholder could without fear of retribution, expose any immoral or unethical conduct by any other stakeholder (King, 1994a:25).

4.5.2 Internal control and going concern

Internal Control - Integrated Framework defined internal control as (COSO, 1992:9):
"a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations."

Clearly internal control extended beyond financial control. It included the whole system of controls: financial, operational and compliance with legal requirements and internal policies.

The board of directors was ultimately responsible for the system of internal control in an organisation and for monitoring its effectiveness. As a matter of practicality, the board of directors would normally delegate the detailed design and operation of the system and some of the monitoring activities (KPMG, 1995:19).

A system of internal control was essential to all successful enterprises. The King Report therefore recommended that the directors should make a statement in the financial statements in relation to effectiveness of the system of internal control (1994a:34).

In order to report on the effectiveness of the internal control system, directors would place reliance on the assurance provided by external audit, internal audit and management (KPMG, 1995:23).

Management should therefore adopt a formal process to provide the required assurance. "Control self-assessment" provides a comprehensive and widely accepted framework for providing such assurance.
Leech (1994:7) defined control self-assessment as a team driven management approach which allowed workgroups to identify the business objectives they should be fulfilling, while assessing the adequacy of the controls in place to meet those objectives. It was therefore a "bottom-up" approach that involved all employees at all levels of an organisation.

Control self-assessment would therefore provide the directors with credible support regarding assertions on internal control.

Assurance on a company's ability to continue as a going concern went hand in hand with an effective system of internal control. However, due to the inherent limitations of a system of internal control, other matters should be specifically taken into account when assessing a company's ability to continue as a going concern. These may include forecasts and budgets, borrowing requirements, liability management, contingent liabilities, products and markets, and financial risk management (KPMG, 1995:179).

The King Report recommended that the directors' report should state that there was no reason to believe that the business would not continue as a going concern in the ensuing financial year. If there was a reason to believe that it might not, the reason should be disclosed and explained. In addition, the external auditors should comment on the directors' report (1994a:21).
4.6 Audit committees

Traditionally, an audit committee was a committee of the board of directors, established primarily to provide additional assurance regarding the quality and reliability of both the financial information used by the board of directors and the financial statements of the company (KPMG, 1995:104).

Although the directors had a primary responsibility for fair presentation in the financial statements, the directors relied in many cases on management for the preparation of the financial statements. However, such reliance did not relieve the directors of their ultimate responsibility for fair presentation in the financial statements. Hence the need for the objectivity and credibility provided by an audit committee (KPMG, 1995:104).

The King Report has broadened the above traditional view when it defined the role of audit committees as assisting the board of directors with discharging its responsibility to (1994a:51):

4.6.1 safeguard the company's assets,
4.6.2 maintain adequate accounting records, and
4.6.3 develop and maintain effective systems of internal control.

From the above it was clear that the role of an audit committee was not confined to financial matters only as a system of internal control covered both financial and operational controls.

The King Report identified five main areas of responsibility for the audit committee (1994a:51, 52):

4.6.4 Review the internal control structure, including financial control, accounting systems and reporting.
4.6.5 Review the internal audit function.
4.6.6 Liaison with external auditors.
4.6.7 Monitoring the compliance of the entity with legal requirements.

4.6.8 Monitoring compliance with the entity's code of conduct.

From the above it was clear that audit committees should become stronger and play a broader, more active role. Therefore, the King Report stated that the primary functions of an audit committee should include reviewing (1944a: 20):

4.6.9 financial statements with both management and the external auditors prior to their approval by the board,

4.6.10 accounting policies adopted, or changes made or contemplated,

4.6.11 effectiveness of the annual external audit, ensuring emphasis is placed on areas where the committee, management or the external auditors believe special attention is necessary,

4.6.12 significant transactions that are not a normal part of the entity's business,

4.6.13 effectiveness of the internal audit function,

4.6.14 co-ordination of approach between the internal and external auditors,

4.6.15 interim financial information,

4.6.16 effectiveness of management information and other systems of internal control, and

4.6.17 recommending the quantum of the audit fees.

Additional functions that may be performed by an audit committee within the broad areas of responsibility were (KPMG, 1995: 104, 105):

4.6.18 Assessing and reviewing the risk assessment process of the company.

4.6.19 Assessing the performance of financial management.

4.6.20 Reviewing related party transactions of the company.

4.6.21 Reviewing policies on sensitive issues or practices, for example environmental issues.

4.6.22 Reviewing the adequacy of insurance coverage.
4.6.23 Reviewing reports from internal audit to ensure that, where major deficiencies or breakdowns in controls or procedures have been identified, appropriate and prompt remedial action is taken by management.

4.6.24 Reviewing external audit reports, management letters and debriefing memoranda to ensure that prompt action is taken by management in respect of those reports.

4.6.25 Reviewing the reports on major defalcations, frauds or thefts from the company.

4.6.26 Monitoring the compliance of the company with the Companies Act, 1973 and the listings requirements of the Johannesburg Stock Exchange, if applicable.

In addition, where companies adopt control self-assessment as referred to in 4.5.2 above, the audit committee should also be the custodian of the self-assessment process.

In conclusion, audit committees were of great benefit to business and organisations, regardless of size. By playing a pro-active role, an audit committee enhanced the credibility of reports to stakeholders (Coopers & Lybrand, 1995:4). Marx (1992: 308) concludes that an audit committee significantly enhanced the effectiveness and quality of the audit process.

4.7 The model of combined assurance

KPMG developed the concept of combined assurance (KPMG, 1995:23) which provided a model for the key players in the risk management process to work together to provide assurance to the board of directors, who had the primary responsibility of providing assurance to shareholders and other stakeholders.
As illustrated in Figure 4.1 below, the combined assurance model involved external auditors working in partnership with management in the internal auditors to provide assurance, through the audit committee, to the board of directors that financial systems and information can be relied upon (KPMG, 1995:23).

It is critical however that the board understood the basis of the assurance it received and clearly distinguished between parties who were part of the financial systems and controls and parties who contributed to these systems and controls (KPMG, 1995:23).

Figure 4.1: The KPMG Combined Assurance Model
The model therefore suggested that the combined assurance covered those areas that were addressed by all three assurance providers. From the description of the model it suggests that combined assurance is provided over financial and accounting controls. Suggested improvements on the KPMG model were presented in chapter 5.

4.8 Conclusion

The three classes of stakeholders, being shareholders, contractual stakeholders and non-contractual stakeholders, had specific needs as regards to assurance being provided to them. However, the common thread in this assurance needs was assurance on the effectiveness of the system of internal control to ensure the company's ability to continue as a going concern.

Three main sources of assurance providers were identified as being the external audit function, the internal audit function and management. All three of these assurance providers had a distinctively different role in corporate governance and providing assurance to stakeholders.

Audit committees had an important role in co-ordinating the nature, extent and focus of the assurance provided by the three assurance providers to ensure that sufficient levels of assurance was provided to the board of directors and ultimately to all stakeholders.

Assurance on financial and accounting controls were provided by all three of the assurance providers. To this end, KPMG has developed a model of combined assurance.
The model's focus was on financial and accounting controls and it did not address the issue of internal control beyond financial and accounting controls. This narrow focus was therefore regarded as a weakness and improvements to the model were considered in chapter 5.
CHAPTER 5: THE EFFECTIVENESS OF THE KING REPORT

5.1 Introduction

The purpose of this chapter was to establish whether or not the King Report would necessarily lead to more effective corporate governance in South Africa and to investigate a model to improve the quality of assurance to stakeholders.

The effectiveness of the King Report was considered in terms of both quantity and quality. The point of departure was whether or not the report by the King Committee achieved its objectives within its terms of reference by considering the quantitative aspects of the King Report. The chapter also considered the qualitative issues that were not adequately addressed by the King Report and evaluated the impact thereof on the effectiveness of corporate governance in South Africa.

The chapter concluded with establishing a combined assurance model that was an improvement on the KPMG Combined Assurance Model.

5.2 The King Committee and its terms of reference

The Cadbury Committee in the context of its terms of reference considered, primarily, financial reporting and accountability, good practice concerning the responsibilities of executive and non-executive directors, the case for audit committees, the principal responsibilities of auditors and the links between shareholders, boards and auditors (King, 1994a: 3).
The King Committee's terms of reference were much wider than those of Cadbury as they included the matters investigated by Cadbury as well as a Code of Ethical Practice for business enterprises in South Africa (1994a: 3).

The King Committee was also charged with having to take into account the special circumstances prevailing in South Africa, more particularly the emergence of a new class of entrepreneur being members of the communities that were disadvantaged by the Apartheid era (1994a: 3).

The King Committee's terms of reference were included in Appendix II of the King Report. The terms of reference was considered individually to establish whether not they had been achieved.

5.2.1 Code of Practice

The committee was requested to consider and make recommendations on a Code of Practice on the financial aspects of corporate governance (King, 1994a: 43). The Code of Corporate Practices and Conduct (King, 1994b) was developed and therefore it was considered that this objective was achieved.

5.2.2 Simpler reporting

The committee should have strived to recommend simpler reporting without sacrificing the quality of information (King, 1994a: 43).

The committee recommended that the board should present as simple a report as possible to stakeholders, but the quality of the information should be based on the guidelines of promptness, relevance, openness
and substance over form (King, 1994a: 29). Therefore it was considered that this objective was achieved.

5.2.3 Guidelines for ethical practices

The committee was tasked to lay down guidelines for ethical practices in business enterprises in South Africa (King, 1994a: 43).

The Code of Ethics for enterprises and all who deal with enterprises (King, 1994c) was issued and therefore it was considered that this objective was achieved.

5.2.4 Members of disadvantaged communities

In applying its terms of reference, the committee was requested to have regard for the special circumstances existing in South Africa, more particularly the entrance into the business community of members of disadvantaged communities (King, 1994a: 43).

This matter was addressed in Chapter 16 of the King Report dealing with stakeholder links (1994a: 23) and Chapter 17 of the King Report dealing with affirmative action (1994a: 24). The King committee also issued affirmative action guidelines (King, 1994d). It was therefore considered that this objective was achieved.

5.2.5 Links between specific role-players

The committee was tasked to establish, forge and maintain links between shareholders, board of directors, auditors and other stakeholders (King, 1994a: 44).
5.2.6 Code of Conduct

A code of conduct setting out best business practices, including ethical practices in all business enterprises which should include the internal relationships in enterprises so as to enhance the standards of ethics in business had to be developed (King, 1994a: 44).

The Code of corporate practices and conduct (King, 1994b) was issued and the ethics considerations were also addressed in the Code of Ethics for enterprises and all who deal with enterprises (King, 1994c). It was therefore considered that this objective was achieved.

5.2.7 Compliance mechanisms

The committee had to establish mechanisms to ensure adoption and compliance of all interested parties and appropriate sanctions for non-compliance (King, 1994a: 44).

The committee adopted a mechanism of voluntary compliance enforced by peer pressure and it recommended that disclosure on the extent of compliance with the Code of corporate practices and conduct became a
listing requirement of the Johannesburg Stock Exchange (King, 1994a: 36).

The recommendation was subsequently included in the Johannesburg Stock Exchange listings requirements and therefore it was considered that the above objective was achieved.

5.2.8 Recommendations on specific issues

The committee was requested to make recommendations on the following specific issues (King, 1994a: 43):

5.2.8.1 The responsibilities of executive and non-executive directors as regards the requirements to review and report on performance and viability to shareholders and other interested parties.

5.2.8.2 The monitoring and quality of information received by the board.

5.2.8.3 The frequency, substance and form of information to shareholders, stakeholders and the community at large to be given in as simple a manner as possible without sacrificing the quality of the information.

5.2.8.4 The question of the appointment of audit, remuneration and nomination committees of a board, the composition of those committees and their respective roles.

5.2.8.5 The principal role of the external auditors, their responsibilities and the extent and value of the audit in the special circumstances existing in South Africa.

5.2.8.6 The role of internal auditors and the reliance on their work by the external auditors.
5.2.8.7 the presence of the external auditors at half-yearly and annual results board meetings, and whether or not the external auditors should review the interim results.

All of the above issues were addressed in the recommendations made by the committee (King, 1994a: 26) and therefore it was considered that the above objectives were achieved.

It can therefore be concluded that the King Committee achieved its terms of reference in full. It should however be noted that this conclusion was based on the quantitative aspects of the committee's terms of reference.

However, in order to reach an overall conclusion on whether or not the King Report would necessarily lead to effective corporate governance in South Africa, the King Report should be considered in terms of its qualitative aspects.

5.3 **Focus on the financial aspects of corporate governance**

In its terms of reference, the King Committee was requested to focus on the financial aspects of corporate governance (1994a: 43). Included in the discussion on the board of directors, the report stated that one of the main functions of the board is to ensure that a company has adequate systems of internal controls, both operational and financial (1994a: 5).

One of the committee's recommendations was that the directors' report should include a statement that an effective system of internal control was being maintained (1994a: 28).
The format of a suggested statement on the system of internal control was also included in the report and includes the following (1994a: 20):

"Your directors report that the company's internal controls and systems are designed to provide reasonable assurance as to the integrity and reliability of the financial statements and to adequately safeguard, verify and maintain accountability of its assets."

The focus was therefore clearly on financial and accounting controls. As indicated in chapter 3, it was regrettable that the King Report back-tracked on this issue and that the Code of Corporate Practices and Conduct was watered down even further by not indicating where the directors' statement on internal control should be disclosed in the annual report (1994a: 34) as disclosure on the extent of compliance with the Code, and not the recommendations, is required by the Johannesburg Stock Exchange.

The main weakness of focusing on financial and accounting controls was that the risks attached to operational controls and compliance with laws and regulations were not taken into account.

For example, an unqualified statement on the effectiveness of internal financial controls may have been issued while at the same time a company ran the risk of having its entire operations shut down as a result of a contravention of occupational safety legislation.

The focus on financial and accounting controls was probably the result of the recommendation by the King Committee that the external auditors should concur with the directors' statement on internal control (1994a: 20). If the directors' statement on internal control goes beyond financial and accounting controls, the external auditors may not be in a position to concur with the
directors' statement as an evaluation of non-financial controls fell outside the scope of the external audit.

In the spirit of good corporate governance, it was more appropriate for directors to report on the entire system of internal control, both financial and operational. It was therefore appropriate for the external auditors to report on the directors' statement in so far as it related to internal financial and accounting controls and alternative means should be investigated to provide additional and/or independent assurance on the effectiveness of non-financial internal controls. It was recommended that this issue forms the topic of further research.

The focus on financial and accounting controls therefore had an adverse impact on the quality of the King Report.

5.4 Independence of the external audit function

The King Report acknowledged that the objectivity of the audit function was adversely affected by the framework in which auditors operated (1994a: 18). The report also suggested that an audit committee chaired by a non-executive director, could maintain the objectivity between the auditors and management and, in the audit committee, differences in opinion between the two can be aired, discussed and agreed upon (1994a: 19).

In addition, the report stated that one of the functions of the audit committee was to recommend the quantum of the audit fees (1994a: 53). It can be argued however, that true external audit independence could not be achieved if the external auditor was remunerated by the parties on which performance it attests to.
It was acknowledged that where the quantum of an audit fee was recommended and approved by an audit committee chaired by, and consisting of a majority of non-executive directors did address the problem to some extent. However, the external audit function also attested to the performance of non-executive directors and therefore it was concluded that the King Report did not address the problem adequately.

No specific solution currently exists and this issue should form the topic of future research.

5.5 Emphasis on disclosure

As a result of the King Report, corporate governance in South Africa was driven from a disclosure point of view. The report referred to the directors' report (for example King, 1994a: 9,33) and statements by directors (for example 1994a: 19, 20, 28).

A corporate governance disclosure paradigm was therefore created. This corporate governance disclosure paradigm may be defined as "doing just enough in order to satisfy the disclosure requirements with the objective to be seen to be practising good corporate governance".

The concept of best management practice was only mentioned once in the report: the committee's terms of reference include a code of conduct setting out best management practices, including ethical practices in all business enterprises which should include the internal relationships in enterprises so as to enhance the standards of ethics in business (1994a: 44).
Corporate governance as embodied in best management practice was therefore not about the rules, regulations and disclosure requirements, it was a dynamic process of doing business in such a way that, at the end of the day, all the stakeholders were in a winning position.

Therefore the disclosure paradigm had an adverse effect on good corporate governance as its forced corporate governance to become static. Hence a best management practice paradigm should be created to propel the dynamics of the corporate governance process.

This best management practice paradigm may be defined as "implementing the right business practices in the right way to ensure that no stakeholder is disadvantaged in any way".

It may therefore be submitted that best management practice should be researched and the resulting benchmarks should be formally codified in a similar way as generally accepted accounting practice and generally accepted auditing standards. In addition, it was concluded that the emphasis on disclosure had an adverse effect on the quality of the King Report.

5.6 Assurance to stakeholders

The King Report addressed assurance to stakeholders by way of the internal and external audit functions. (1994a:18-21). Management's role in providing assurance was addressed by this research in section 5 of chapter 4.

A board of directors should be able to reliably demonstrate the assertions on internal control and going concern, i.e. they need evidence to support their statements on internal control and going concern in the annual report. Control
self-assessment as referred to section 5.2 of chapter 4 will provide the board of directors with such evidence.

It was therefore important that the model of combined assurance as referred to in chapter 4.7 was applied. However, management's role in providing assurance to the board of directors, was not addressed by the King Report. It was therefore concluded that this omission had an adverse effect on the quality of the King Report.

5.7 The model of combined assurance revisited

As indicated in chapter 4.7, the KPMG Combined Assurance Model was based on the assurance provided by management, the internal audit function and the external audit function, via the audit committee to the board of directors and ultimately to all stakeholders.

The model suggested that the combined assurance covered those areas that were addressed by all three assurance providers. It was also clear that this form of combined assurance covered the financial and accounting controls.

The three assurance providers should provide assurance on all aspects of organisational performance. It may therefore be submitted that, although assurance was provided on the accounting and financial controls by all three assurance providers, assurance was also provided on the balance of the internal control system by one or a combination of assurance providers. This model should be referred to as the Variable Combined Assurance Model as illustrated in Figure 5.1.
The principles of the model may be illustrated by the following example: a critical business risk such as industrial relations to a labour intensive organisation, may not be addressed by the external audit function. Through control self-assessment, management should provide assurance that this critical business risk was reduced to an acceptable level. In addition, the internal audit function may provide assurance on the management process over this critical business risk if it was part of the internal auditing function's audit coverage plan for a specific financial period.

Therefore the level of assurance on a specific critical business risk would vary according to the source or combination of sources that provided the assurance.

Figure 5.1 The Variable Combined Assurance Model

This research has therefore developed a revised model of combined assurance which would be referred to as the Variable Combined Assurance Model.
Chapter 5: The Effectiveness of the King Report

5.8 Conclusion

The report by the King Committee was measured against the committee's terms of reference and it was concluded that the committee achieved its objectives as regard to the quantitative aspects of corporate governance.

Four qualitative aspects of corporate governance were identified as not being adequately addressed by the King Committee. Firstly, the narrow focus on internal financial and accounting controls disregarded the critical risks attached to operational controls and compliance with laws and regulations.

Secondly, the report did not adequately resolve the fundamental issue of independence of the external audit function where that function was remunerated by the body on which performance was attested to.

Thirdly, the King Report created a disclosure paradigm which forced corporate governance to become static. A best management practice paradigm was required to propel the dynamics of the corporate governance process.

In the fourth place, the King Report did not adequately address management's role in providing assurance. Control self-assessment as a management process would allow boards of directors to reliably demonstrate their assertions on internal control and going concern.

Finally, by formalising management's role in the corporate governance process to provide assurance on critical business risks, this research improved on the KPMG Combined Assurance Model to create the Variable Combined Assurance Model.
CHAPTER 6: CONCLUSION

6.1 Introduction

The purpose of this chapter was to summarise the research findings and to formulate an overall conclusion on whether or not this short dissertation achieved its objectives.

6.2 Summary of research findings

In chapter 1 the classic UK (before and after the Cadbury Report), German and Japanese corporate governance models were examined. The South African corporate governance framework, as codified by the King Report which fundamentally based the South African framework on the Cadbury model, was also examined.

Chapter 2 recognised that a corporate governance framework consisted of two principal elements that were dealt with separately in the two subsequent chapters:

1. The board of directors (chapter 3).
2. Providing assurance to stakeholders (chapter 4):
   - The mechanisms that provide assurance on:
     * financial reporting to stakeholders and users of financial statements,
     * activities of the board of directors and management,
     * the effectiveness of the internal control, and
     * going concern.
Chapter 3 identified the fiduciary duties of directors as a duty of loyalty and a duty of care and skill. Directors should always act in the best interest of the company and should display the level of skill that may be reasonably expected from persons with their knowledge and experience.

The King Report provided additional guidance in respect of directors' duties and made specific recommendations on the structure and functioning of the board of directors. The main purpose of the guidance and recommendations were to ensure that directors were aware of their fiduciary duties and to ensure that boards of directors functioned more effectively.

The duties and responsibilities of non-executive directors did not differ from those of executive directors. The concept of non-executive directors was introduced to bring independence into board deliberations in order to improve the overall effectiveness of the board.

As identified in chapter 4, the three classes of stakeholders, being shareholders, contractual stakeholders and non-contractual stakeholders, had specific needs as regards to assurance being provided to them. However, the common thread in this assurance needs was assurance on the effectiveness of the system of internal control to ensure the company's ability to continue as a going concern.

Three main sources of assurance providers were identified as being the external audit function, the internal audit function and management. All three of these assurance providers had a distinctively different role in corporate governance and in providing assurance to stakeholders.

Audit committees had an important role in co-ordinating the nature, extent and focus of the assurance provided by the three assurance providers to ensure
that sufficient levels of assurance were provided to the board of directors and ultimately to all stakeholders.

Assurance on financial and accounting controls were provided by all three of the assurance providers. To this end, KPMG developed a model of combined assurance.

The KPMG model's focus was on financial and accounting controls and it did not address the issue of internal control beyond financial and accounting controls. This narrow focus was therefore regarded as a weakness and improvements to the model were considered in chapter 5.

Chapter 5 measured the report by the King Committee against the committee's terms of reference and it was concluded that the committee achieved its objectives as regard to the quantitative aspects of corporate governance. However, a true corporate governance model should adequately address the qualitative aspects of corporate governance.

Four qualitative aspects of corporate governance were identified in chapter 5 as not being adequately addressed by the King Committee. Firstly the narrow focus on internal financial and accounting controls disregarded the critical risks attached to operational controls and compliance with laws and regulations.

Secondly, the report did not adequately resolve the fundamental issue of independence of the external audit function where that function was remunerated by the body on which performance was attested to.

Thirdly, the King Report created a disclosure paradigm that forced corporate governance to become static. A best management practice paradigm was required to propel the dynamics of the corporate governance process.
In the fourth place, the King Report did not adequately address management’s role in providing assurance. Control self-assessment as a management process would allow boards of directors to reliably demonstrate their assertions on internal control and going concern.

Finally, by formalising management’s role in the corporate governance process to provide assurance on critical business risks in chapter 5, this research improved on the KPMG Combined Assurance Model to create the Variable Combined Assurance Model.

6.3 Conclusion and opportunities for further research

It was established in chapter 2 that the principle of a two-tiered board of directors, as embodied in the German model, could be appropriate in the South African business environment. It was recommended that this issue becomes the topic of further research.

The King Committee Report was not endorsed by labour representatives due to the report’s lack of recognising worker participation at board level. It therefore appeared that the unitary board structure as recommended by (King, 1994a:26) did not adequately address worker participation. Therefore it was recommended that this issue becomes the topic of further research.

The concept of two audit appointments per the Japanese corporate governance model, as dealt with in chapter 2, should form the topic of further research as it may serve to strengthen and define more clearly the roles of internal and external auditors in the South African corporate governance context.
It was argued that, as long as the principle of being paid by the persons on who's performance was attested to, was not properly addressed, true external audit independence would not be adequately resolved. Therefore it was recommended that this issue forms the topic of further research.

Baxter and Rarick (1987:243) proposed the concept of education for the moral development of managers. Although many questions may be asked around this proposal, its application in the South African context should be subject of further research.

Chapter 5 identified the need to research best management practice and to codify the resulting benchmarks in a similar way as generally accepted accounting practice and generally accepted auditing standards.

The two main objectives of this short dissertation were formulated in chapter 1 as evaluating the King Report on Corporate Governance to establish whether or not the recommendations of the report would necessarily lead to more effective corporate governance in South Africa and to investigate and/or formulate a model to improve the quality of assurance provided to stakeholders.

The King Report was evaluated in terms of quantitative and qualitative aspects. It was concluded that the report achieved its objectives in terms of quantitative aspects. However, the King Report did not adequately address the qualitative aspects of corporate governance in four main areas. This had an adverse effect on the overall quality of the report and therefore it was concluded that the King Report on Corporate Governance may not necessarily lead to more effective corporate governance in South Africa.
The Variable Combined Assurance Model was developed in this short dissertation. This model will provide stakeholders with variable levels of assurance on all aspects of organisational performance. It was an improvement on the KPMG Combined Assurance Model that provided assurance to stakeholders on financial and accounting controls.

It can therefore be concluded that this short dissertation achieved its objectives.
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