EVALUATING THE EFFECTIVENESS OF THE AUDIT COMMITTEE: A CASE FOR PROTECTION OF THE INDEPENDENCE OF THE AUDIT COMMITTEE UNDER THE SOUTH AFRICAN CORPORATE STRUCTURE

by

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A thesis submitted in fulfilment of requirements for the degree of Doctor of Laws

at the

UNIVERSITY OF THE WESTERN CAPE

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DECLARATION

I, **NELSON THABANG KGWETE, 4176820,** hereby declare that I have read and understood the University's rules and regulations for submission of research work which includes, but not limited to, plagiarism and ethical conduct and further confirm that this work is my own and conforms to the afore stated.

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ACKNOWLEDGEMENTS

To my mother Molokane Kgwete, I want to thank you for all the love and care, *mma*. I recognise and appreciate the struggle you went through to raise my siblings and I as single mother. *Ke a leboga Moramadi.*

I also want to thank my eldest brother, Sam Kgwete, for the guidance and support growing up. You played and continue to play a big role in my life, which my own father, whom I do not even know, has failed to play. I know that you have never doubted me on anything.

To my kids, Thabiso, Neo, Kemelo and Kamano - daddy loves so much. I went through this journey having inspired by the beautiful smiles on your faces. May *Banareng* protect you for me, as I continue to do my best for you and your mother. You are the best thing to ever happen to me.

I certainly would not have completed this doctoral journey without the support and encouragement of my wife, Raisibe Kgwete. *Ke a go leboga dikgomo tsa banareng*. You have given me a home and a beautiful family without which I am absolutely nothing. Please continue to inspire me through your warm heart. This doctoral degree is for us. Thank you for the support and encouragement, Modipadi.

A big thank you and appreciation to my supervisor, Professor BM Mupangavanhu. Thank you for being part of my doctoral journey and holding me by hand. The encouragement you afforded me and the challenge you have given me to push myself a bit harder, are all appreciated. You gave me confidence at times when I doubted myself. I am indebted to you, Prof. Your commitment to this project was inspirational. I hope to collaborate with you in future projects because I have witnessed just how passionate you are about the work you do. Thank you once again, my Prof.

Finally, thank you to the University of the Western Cape for allowing me to pursue this doctoral dream at this great institution.

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ABSTRACT

The recent wave of corporate governance failures in South Africa has exposed, among others, weaknesses in the realm of the audit committee as an oversight body within the corporate structure, both in private and public sectors. These governance collapses happened, despite the fact that the majority of these companies had audit committees.

In this thesis, the provisions relating to the audit committee under the Companies Act 71 of 2008 ('the Companies Act 2008') and the Public Finance Management Act 1 of 1999 ('the PFMA') are analysed, with a particular focus on the adequacy of the promotion and protection of the independence of the audit committee within the corporate structure in South Africa. The purpose is to demonstrate that the Companies Act 2008 and the PFMA do not adequately protect the independence of the audit committee.

Section 94 of the Companies Act 2008 deals, *inter alia*, with the composition of the company's audit committee and appointment of members thereto. However, the Companies Act 2008 does not make provision for the procedure and/or grounds for the removal of members of the audit committee. Further, neither section 94 nor any other section of the Companies Act 2008 makes clear provision to empower any person or a structure or body of persons to remove members of the company's audit committee. For purposes of state-owned enterprises ('SOE'), the PFMA makes provision for the establishment of the audit committee in terms of section 77. Both the Companies Act 2008 and the PFMA, including the relevant Treasury Regulations ('Treasury Regulations for PFMA') do not appear to have mechanisms which safeguard the independence of the audit committee, particularly from the governing bodies.

This thesis examines these shortcomings in detail and argues that the independence of the company's audit committee is not only weakened by possible direct or indirect involvement of the governing bodies (boards of directors of privately-owned companies and accounting authorities of SOEs) in the general configuration of the audit committee, but also that the independence

of the committee is not sufficiently protected from these governing bodies. The independence of the audit committee and the protection of the independence are necessary for effective functioning of the committee to, among other things, (a) improve the integrity and quality of financial reporting, (b) strengthen the committee's oversight function, (c) enhance the auditor's independence, (d) enforce regulatory and legislative compliance, and (e) promote sound corporate governance for the benefit of the community of stakeholders. In other words, the independence of the audit committee and protection thereof are essential to promote and enhance the effectiveness of the audit committee.

KEY WORDS/PHRASES: *Audit committee; Auditors; Board of directors; Board committees; Companies Act 71 of 2008; Company committees; Corporate governance; Governing bodies; Independence; Public Finance Management Act 1 of 1999; Regulations;; Shareholders; Treasury*.

CHAPTER 1: BACKGROUND AND INTRODUCTION TO STUDY

1.1 INTRODUCTION

Because of the current spate of profound corporate governance failures and financial irregularities scandals in South African private sector corporations and major public entities,[1] the autonomous role of the audit committee under the country's corporate governance structure may soon come under the microscope. In the view of the former Auditor-General of South Africa, accounting scandals dent South Africa's image.[2] From the aforesaid, some of the questions which may arise from these corporate governance failures and accounting scandals, not least from auditors, accountants and corporate lawyers, are: Where is the company's audit committee? How were the noticeable governance transgressions and grave accounting and reporting irregularities not flagged? Were the audit committee and the auditors complicit? Has the audit committee discharged its statutory and any delegated responsibilities independently without fear or favour?

As Marx[3] correctly remarked in his thesis, these corporate scandals, both locally and internationally, generally had the following in common: poor corporate governance practices, fraudulent financial reporting, creative accounting and auditor inefficiency and independence issues, despite the fact that audit committees existed at most of these companies. In June 2019, the Business Day newspaper quoted the Auditor-General as saying that 'the happenings of this current period have become a replication of what we have been accustomed to over a number of years,'[4] and further pointing out that 'those who presided over these scandals often left with bulging back pockets'.[5] This raises a question: why would those who preside over

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[1] See the discussion of the problem statement in 1.3.
[2] See Nkentane L 'Accounting scandals dent SA's image, says Kimi Makwetu' *Business Day* 06 June 2019 available at https://www.businesslive.co.za/bd/national/2019-06-06-dubious-accounting-and-auditing-affecting-foreign-investment-says-kimi-makwetu/ (accessed on 07 June 2020). Kimi Makwetu was the Auditor-General of South Africa between 2013 and 2020.
[3] Marx B *An analysis of the development, status and functioning of audit committees at large listed companies in South Africa* (published DCOM thesis, University of Johannesburg 2008) 10.
[4] Nkentane L 'Accounting scandals dent SA's image, says Kimi Makwetu' *Business Day* 06 June 2019 available at https://www.businesslive.co.za/bd/national/2019-06-06-dubious-accounting-and-auditing-affecting-foreign-investment-says-kimi-makwetu/ (accessed on 07 June 2020).
[5] Nkentane L 'Accounting scandals dent SA's image, says Kimi Makwetu' *Business Day* 06 June 2019 available at https://www.businesslive.co.za/bd/national/2019-06-06-dubious-accounting-and-auditing-affecting-foreign-investment-says-kimi-makwetu/ (accessed on 07 June 2020).

these abysmal corporate catastrophes do so with impunity despite the watchful eye of the audit committees?

This thesis critically examines the protection of the independence of the audit committees under the South African business governance structures, specifically with reference to the Companies Act 2008 and the PFMA. The purpose is, as it will be expounded below, to demonstrate that the South African body of corporate law does not sufficiently protect the independence of the audit committee.

To provide a contextual background, this introduction provides a brief exposition of the South African companies' statutory requirements to keep financial records and produce financial statements. This segment further provides a brief overview of the requirements for auditing of annual financial statements and financial reporting. This introductory part also introduces the concept of audit committee under the following sub-topics: a brief historical overview, the audit committee under the Companies Act 2008 and the PFMA, as well as the relevant regulations.

1.1.1 Company's accounting records and financial statements

South African companies are statutorily required to keep accounting records.[6] This is to enable companies to satisfy the obligations under the Companies Act 2008 and any other law in respect of preparation of the companies' financial statements.[7] The Companies Act 2008 defines accounting records as information in written or electronic form concerning the financial affairs of a company as required in terms of that Act, including but not limited to, purchase and sales records, general and subsidiary ledgers and other documents and books used in the preparation of financial statements.[8] The importance of keeping accounting records is accentuated by the provisions of section 28(3) of the Companies Act 2008, which create an offence for companies which, with an intention to deceive or mislead any person, fail to keep accurate and complete accounting records[9] and/or to keep records other

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[6] S 28(1) of the Companies Act 2008.
[7] S 28(1)(a) of the Companies Act 2008; Also see Davis et al *Companies and other business structures in South Africa* (2008) 117.
[8] See s 1 of the Companies Act 2008.
[9] S 28(3)(a)(i)(aa) of the Companies Act 2008.

than in the prescribed manner and form.[10] It is also an offence for the company[11] or any person[12] to falsify the company's accounting records.

From the foregoing, it is clear that accounting records are essential for the preparation of the company's financial statements. Financial statements of the company include annual financial statements and provisional annual financial statements; interim or preliminary reports; group and consolidated financial statements in the case of a group of companies; and financial information in a circular, prospectus or provisional announcement of results, that an actual or prospective creditor or holder of the company's securities, or the Companies and Intellectual Property Commission ('CIPC'), Panel or other regulatory authority, may reasonably be expected to rely on.[13] Accordingly, accounting records and financial statements must disclose all facts that may influence the judgment of an informed reader.[14] The heading of Part C in Chapter 2 of the Companies Act 2008 reads as follows: *Transparency, accountability and integrity of companies*. This suggests that the purpose of Part C in Chapter 2, which encompasses, among others, the provisions dealing with accounting records and financial statements, is to give effect to one of the purposes of the Companies Act 2008 as contemplated in section 7 of that Act, specifically in respect of 'encouraging transparency and high standards of corporate governance as appropriate, given the significant role of enterprises within the social and economic life of the nation'.[15] The financial statements of companies are regulated in terms of the provisions of sections 29 to 31 of the Companies Act 2008.[16] As it is demonstrated throughout this thesis, the audit committee forms part of this statutory regulation.

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[10] S 28(3)(a)(i)(bb) of the Companies Act 2008.
[11] S 28(3)(a)(ii) of the Companies Act 2008.
[12] S 28(3)(b) of the Companies Act 2008.
[13] See s 1 of the Companies Act 2008.
[14] Gibson GH *Financial Reporting & Analysis Using Financial Accounting Information* 13th ed (2012) 17.
[15] S 7(b)(iii) of the Companies Act 2008.
[16] It is important to note that ss 24 -28 are also very relevant to financial statements and a company's financial reporting standards. S 24 for example deals with form and standards for company records; s 25 deals with location of company records; s 26 provides for access to company records; s 27 provides for the financial year of the company, while s 28 deals with the accounting records.

1.1.2 Auditing of annual financial statements and financial reporting

The annual financial statements of companies are regulated in terms of the provisions of section 30 of the Companies Act 2008. Of particular importance for the purpose of this discussion is that public companies are obligated to have their annual financial statements audited.[17] The annual financial statements of any other profit or non-profit company must be audited, provided the criteria set out in subsections 30(b)*(i)* or 30(b)*(ii)(aa)* of the Companies Act 2008 are satisfied, or be independently reviewed in terms of provisions of subsection 30(b)*(ii)(bb).* Further, the audited annual financial statements of the company must include the auditor's report.[18] This is to ensure that the reports, including annual financial statements, issued by companies enable stakeholders to make informed assessment of the companies' performance, and their short, medium and long-term prospects.[19]

The Companies Act 2008 has introduced several good corporate governance mechanisms with respect to the integrity of financial information, the auditor and the audit committee,[20] among others. Section 34 of the Companies Act 2008 creates additional accountability requirements for certain companies. Notably, public companies and SOEs are required to comply with the extended accountability requirements set out in Chapter 3 of the Companies Act 2008.[21] Among other things, Chapter 3 of the Companies Act 2008 encompasses the provisions which deal with the appointment of auditors[22] and audit committees[23]. Significantly, there is an interaction between the auditors and the audit committee from the perspective of appointment of auditors and the oversight of the audit function, the auditing of financial statements for the purpose of financial reporting and the duties of the audit committee as they relate to the auditors, as set out in section 94(7) of the Companies Act 2008. The importance of the audit committee in relation to accounting records

[17] S 30(2)(a) of the Companies Act 2008.
[18] S 30(3)(a) of the Companies Act 2008.
[19] See Principle 5 under Part 5.2 of the *King IV Code*.
[20] Cassim et al *The Law of Business Structures* 2 ed (2021) 396.
[21] S 34(1) of the Companies Act 2008. Private companies, personal liability companies, or non-profit companies are generally not required to comply with the provisions set out in Chapter 3, except to the extent contemplated in section 84(1)(c), or as set out in the company's MOI (see s 34(2) of the Companies Act 2008).
[22] Part C of Ch. 3 of the Companies Act 2008.
[23] Part D of Ch. 3 of the Companies Act 2008.

and financial statements flows from Part C of Chapter 2 of the Companies Act 2008 and is entrenched in section 94 of the same Act.

1.1.3 The concept of audit committee

1.1.3.1 A brief historical overview

The concept of audit committee is not new.[24] It is a global phenomenon.[25] The concept was introduced as early as the nineteenth century by the Great Western Railway Company in the United Kingdom ('the UK').[26] In the United States of America ('the USA'), the concept dates back to the late 1930s[27] but it was the promulgation of the Sarbanes-Oxley Act of 2002 ('the SOX Act') in that country that saw amplification of the need for audit committees in both private and public sectors.[28] A fundamental feature of an effective audit committee is its independence from the company's management.[29]

In South Africa, the establishment of audit committees by large companies was, by and large, a voluntary exercise.[30] However, with the amendment of the Companies Act 61 of 1973[31] ('the Companies Act 1973') and later the introduction of the Companies Act of 2008, it has since become mandatory for certain companies to establish and maintain audit committees.[32] For public entities, the promulgation of the PFMA in 2000 was a cornerstone for transparency, accountability, and sound management in South African SOEs.[33] This point is further expounded in point 1.1.3.3 below.

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[24] Marx B & Du Toit E 'The impact of accounting standards developments and financial reporting complexities on the audit committee' (2009) 3(2) *Journal of Economic and Financial Sciences* 116.

[25] Akwenye NJ, Chata T & Benedict OH 'Establishment of audit committee in government ministries of a developing country' (2016) 6(4) *Risk Governance & Control: Financial Markets & Institutions* 282.

[26] Marx B (2008) at 1; Also see Marx B & Du Toit E (2009) 116.

[27] Akwenye NJ, Chata T & Benedict OH (2016) 282.

[28] Akwenye NJ, Chata T & Benedict OH (2016) 282.

[29] Global Institute of Internal Auditors *Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations* (2014) 12.

[30] Marx B (2008) 6.

[31] See s 24 of Corporate Laws Amendment Act 24 of 2006.

[32] S 84(4)(c) of the Companies Act 2008.

[33] See s 2, read with s 3(1)(b), of the Public Finance Management Act 1 of 1999.

1.1.3.2 The Companies Act 2008

Amongst other fundamental features it has introduced into South African corporate law, the Companies Act 2008 makes it obligatory for certain companies to appoint an audit committee.[34] As it would be evident from the chapter[35] heading, the objective of section 94 of the Companies Act 2008 is to 'enhance accountability and transparency' in corporations, which supposedly gives effect to a relevant purpose of that Act.[36] Section 94(2) of the Companies Act 2008 prescribes that a public company or a state-owned company ('SOC') or any other company whose Memorandum of Incorporation ('MOI') requires that an audit committee be appointed, must appoint such committee, except where the company is a subsidiary of another company which itself has an audit committee[37] and the audit committee of that other company will perform the functions required under this section on behalf of that subsidiary company.[38] It is assumed the phrase 'other company' in subsection (2)(b) refers to the holding company[39] of that subsidiary.[40]

The audit committee under the Companies Act 2008 is an essential governance enhancement mechanism and a remarkable improvement from the Companies Act 1973, which until 2007, did not make any provision for requirement of appointment of the audit committee. Before 2007, the provisions spanning from section 269 to section 276 of the Companies Act 1973 had only set out the requirements and procedure for appointment of the company's auditors; what happens if and when the company fails to appoint auditors; and the category of persons who were disqualified from being appointed as the company's auditors. Section 24 of the Corporate Laws Amendment Act 24 of 2006 amended the Companies Act 1973 to make provisions for appointment of audit committees for public interest companies.

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[34] S 94(2) of the Companies Act 2008; Also see recommended practice 51 under Principle 8 of *King IV Code*.
[35] Ch. 3 of the Companies Act 2008.
[36] S 7(b)(iii) of the Companies Act 2008.
[37] S 94(2)(a) of the Companies Act 2008.
[38] S 94(2)(b) of the Companies Act 2008.
[39] See s 1, read with in s 2(2)(a) and s 3(1)(a), of the Companies Act 2008 for a definition of a holding company.
[40] See s 1, read with s 3, of the Companies Act 2008 for a definition of a subsidiary company.

Similar provisions are outlined in Part C in Chapter 3 of the Companies Act 2008, which are expansively discussed in this thesis.

From the outset, it must be noted that there appears to be some conflicting views, locally and internationally, as to whether or not the audit committee is a committee of the company's board of directors. For example, Delport suggests that the audit committee is not a committee of the board of directors[41] and that it is an independent committee of the company.[42] Magrane and Malthus, however, hold the view that audit committee is the subcommittee of the company's board of directors.[43] This view is supported by Ferreira[44] and Ncube.[45] Hendrikse and Hefer remark that 'previously, the audit committee was a subcommittee of the board of directors'[46] and that 'the audit committee has been transformed from a board committee to a committee with clear statutory accountabilities'.[47] This appears to suggest that, in South Africa, the audit committee was a subcommittee of the board under the *previous* company law regime and that this position has now changed under the Companies Act 2008.

If it is to be accepted that the audit committee is a subcommittee of the board, then section 72(3) of the Companies Act 2008 applies. This section states that the creation of a board committee, delegation of powers to and actions of that committee do not alone constitute compliance by the directors (individually and collectively as board of directors – emphasis added) of the company with their standards of conduct as contemplated in section 76 of the Companies Act 2008. This, therefore, may entice the board of directors to take an active interest in and potentially interfere with the independent work of the audit committee.

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[41] Delport P *Henochsberg's Commentary on the Companies Act 71 of 2008* (2017) 356; Also see Delport P *New Entrepreneurial Law* 2 ed (2021) at 113, where it is stated that organs of the company are ordinarily board of directors and shareholders but that the Companies Act 2008 has introduced two additional organs of the company, namely the social and ethics committee and the audit committee.

[42] Delport P *New Entrepreneurial Law* 2 ed (2021) 113.

[43] Magrane J & Malthus S 'Audit Committee Effectiveness: A Public Sector Case Study' (2010) 25(5) *Managerial Auditing Journal* 427-443.

[44] Ferreira I 'The effect of audit committee composition and structure on the performance of audit committees' (2008) 16(2) *Meditari Accountancy Research* 93.

[45] Ncube CB 'Transparency and accountability under the new company law' (2010) *Acta Juridica* 67.

[46] Hendrikse JW & Hefer L *Corporate Governance Handbook: Principle and Practice* 3 ed (2019) 389.

[47] Hendrikse JW & Hefer L (2019) 390.

In his doctoral thesis, Marx examines, with authority from various sources, the definition of audit committee and concludes that 'the audit committee should function as a subcommittee of the board of directors of which the majority of members should be independent non-executive directors'.[48] Notwithstanding the opposing views, the functions of the audit committee are critically important; and under the South African corporate governance framework, the functions of the audit committee include, among other things, nominating a registered independent auditor for appointment in terms of the provisions of section 90 of the Companies Act 2008.[49] The audit committee also has the duty to make submissions to the company's board of directors on any matter concerning the company's accounting policies, financial controls, records and reporting[50] and to perform such other oversight functions as may be determined by the board of directors.[51]

It is demonstrated in this study, that the independence of the audit committee cannot be emphasised enough. It is the cornerstone of the audit committee and thus, sacrosanct. As it is suggested that the audit committee is accountable to the board,[52] the question, therefore, arises as to whether or not the independence of the company's audit committee is compromised by the fact that at least three members of such committee are and form part of the company's board of directors[53] in terms of section 94(4)*(a)*, read with subsection (2), of the Companies Act 2008. Although the Companies Act 2008 prescribes that the three members of the company's audit committee must not be executive directors involved in the day to day management of the company's business,[54] it is a settled law that the business and affairs of the company are, nonetheless, managed by or under the direction of the company's board of directors,[55] to an extent that the company's MOI provides otherwise. At this

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[48] Marx B (2008) 42.
[49] S 94(7)(a) of the Companies Act 2008.
[50] Subsection (7)(h).
[51] Subsection (7)(i).
[52] Cassim et al *Contemporary Company Law* 3 ed (2021) 625. Also see Cassim et al *The Law of Business Structures* 2 ed (2021) 312.
[53] Chapter 3 of the Companies Act 2008 does not define the meaning of a *director* for the purpose of that Chapter and neither does s 94 of the Act provide for such definition for the purpose of that section. Therefore, a *director* referred to in s 94 of the Act must be given the meaning defined in s 1, read with s 66, of the Act. It therefore follows that a *director* referred to in s 94 of the Act means a member of the board of directors.
[54] S 94(4)(b)(i) of the Companies Act 2008.
[55] S 66(1) of the Companies Act 2008; *Westerhuis v Whittaker and Other* (4145/2017) [2018] ZAWCHC 76 (26 April 2018) para 18; Also see Principle 1 of *King IV Code.*

juncture, it must be stated that section 66(1) of the Companies Act 2008 does not draw a distinction between executive and non-executive directors in relation to the powers conferred and duties imposed in that section. Further, the appointment and the duties of the audit committee do not reduce the statutory duties and functions of the board of directors, except with respect to the appointment, fees and terms of engagement of the auditor.[56] This makes it conceivable for the board of directors to interfere with the independent function of the company's audit committee. For this reason, among others, this thesis propounds the idea that the independence of the company's audit committee is not adequately protected under the Companies Act 2008.

The Companies Act 2008 defines a director as a member of the company's board of directors.[57] Not only does section 66(1) of the Companies Act 2008 create and impose statutory duty on the board of directors of the company, to manage and/or give direction in respect of management of the business and affairs of the company but also confers statutory authority on the directors, to exercise all of the powers and perform all functions permissible under the Companies Act 2008 and the company's MOI. It is submitted that this includes the three members of the audit committee prescribed by section 94(2) of the Companies Act 2008, who, despite the fact that they must not be involved in the day-to-day management of the company and must not have been so involved in the preceding financial year, nonetheless, may form part of the company's governing body (board of directors or accounting authority). Put differently, nothing in the Companies Act 2008 and Companies Regulations precludes members of the board of directors, who serve on the company's audit committee, from the application of section 66(1) of Companies Act 2008 to them *qua* directors, in respect of the statutory duty and powers fashioned in that section. It is demonstrated in Chapter 5 of this thesis that, the fact that the audit committee of the company is accountable to and its members are, at times, appointed by the company's board of directors compromises the independence of that committee. This thesis advances an argument that the audit committee is an

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[56] S 94(10) of the Companies Act 2008. Also see Cassim et al *Contemporary Company Law* 3 ed (2021) 625.
[57] S 1 of the Companies Act 2008.

independent organ of the company and that its members should only be appointed by the shareholders at a meeting. Flowing from the aforesaid, a case is being made that the audit committee should account to the shareholders of the company in a meeting.

1.1.3.3 The Public Finance Management Act

The object of the PFMA is, *inter alia*, to regulate and secure transparency, accountability, and sound management of the revenue, expenditure, assets and liabilities[58] of public entities listed in Schedule 3 of that Act.[59] Amongst many major public entities listed in Schedule 3 of the PFMA are Eskom, the South African Broadcasting Corporation ('SABC'), Transnet Limited, South African Airways (Pty) Ltd ('SAA'), Denel (Pty) Ltd and Central Energy Fund (Pty) Ltd, which have all suffered serious financial difficulties and corporate governance disasters in the past decade or so.[60] The PFMA also applies to all subsidiaries of the major public entities to which the Act applies.

As with the Companies Act 2008, which applies to all public entities (also referred to as state-owned companies or enterprises), the PFMA makes provision for public entities to appoint audit committees in line with the Treasury Regulations or Instructions.[61] The Treasury Regulations for PFMA are briefly discussed in point 1.1.3.4 below. Section 77 of the PFMA prescribes that the audit committee of public entities must consist of no less than three persons[62] and that in the case of a government department, at least one of the members of the audit committee must be from outside the public service[63], the majority of the members of the audit

[58] S 2 of the Public Finance management Act 1 of 1999.
[59] S 3(1)(b) of the Public Finance management Act 1 of 1999.
[60] For example, the Public Protector's report titled *'When Governance and Ethics Fail'* found symptomatic of pathological corporate governance deficiencies at the SABC, including failure by the SABC board of directors to provide strategic oversight to the National Broadcaster as provided for in the SABC Board Charter and King Report; The SAA was recently placed under business rescue and the erstwhile chairperson of its board of directors was declared a delinquent director by the court; Transnet and Eskom are subject of a crucial testimony at the Judicial Commission of Inquiry into allegations of State Capture, Corruption and Fraud in the Public Sector including Organs of State.
[61] S 76(4)(d) of the Public Finance Management Act empowers the National Treasury to make regulations or issue instructions with regards to the audit committees, their appointment and functioning.
[62] S 77(a) of the Public Finance Management Act 1 of 1999.
[63] S 77(a)(i) of the Public Finance Management Act 1 of 1999.

committee may not be persons in the employ of the department, except with the approval of the relevant treasury[64] and that the chairperson may not be within the employ of the government department.[65] The audit committee, as it relates to government departments falls outside of the scope of this thesis and will, thus, not be discussed.

It is clear from the reading of sections 76 and 77 of the PFMA that the PFMA does not set out any requirements for composition of the audit committee for public entities other than that the committee must comprise at least three members.[66] Section 77(a)*(i)* and *(ii)* only apply in the case of audit committees for government departments. The PFMA does not deal with the appointment, removal and the functions of the audit committees and leaves same for determination by the National Treasury through the relevant regulations and instructions.

1.1.3.4 Treasury Regulations for PFMA

The National Treasury Regulations were gazetted in Government Gazette No 27388, with commencement date of 15 March 2005 and published pursuant to the PFMA ('Treasury Regulations for PFMA'). To enhance internal controls in the public entities, Regulations 3 and 27 of the Treasury Regulations for PFMA make provisions for the establishment and functions of audit committees of public entities to give effect to sections, 51(1)*(a)(ii)*, 76(4)*(d)* and 77 of the PFMA. Of noteworthy relevance for this study is Regulation 3.1.5 of the Treasury Regulations for PFMA, which provides that 'audit committees must be constituted so as to ensure their independence...'. It is argued in this thesis that both the PFMA and the Treasury Regulations for PFMA do not adequately protect and promote the independence of the audit committees in public entities as envisaged in the Regulation 3.1.5 of the Treasury Regulations for PFMA.

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[64] S 77(a)(ii) of the Public Finance Management Act 1 of 1999.
[65] S 77(a)(iii) of the Public Finance Management Act 1 of 1999.
[66] S 77(a) of the Public Finance Management Act 1 of 1999.

1.2 CORPORATE SCANDALS IN SOUTH AFRICA - SETTING THE SCENE

The South African corporate world has recently been and continues to be rocked by overwhelming corporate governance disasters in both private and public sectors. The following are some of the examples: The Steinhoff corporate scandal has been labelled as possibly the biggest case of corporate fraud in South African business history[67] or more aptly, as the 'South Africa's Enron'.[68] With respect to the Steinhoff scandal, its auditor, Deloitte & Touché ('Deloitte'), had to agree to contribute towards payment of claims to the Steinhoff shareholders for economic losses suffered by that company.[69] In the Tongaat Hulett Limited scandal, PriceWaterhouseCoopers ('PwC') investigation into that company's corporate shame found, among other things, that there were a number of governance failures pursuant to which internal policies, guidelines and frameworks were not followed.[70] The PwC investigation into the Tongaat Hulett Limited scandal further found that these governance failures created an environment in which senior executives could initiate or participate in the financial reporting misstatements.[71]

Another example is EOH Holding's corruption scandal. An investigation of corruption at EOH Holding by a law firm ENSafrica has discovered that there was evidence of serious governance failings and wrongdoing in that company.[72] The SOEs were not spared. In 2014, the CIPC issued a warning to the board of directors of, among others, the SABC, informing it that the directors were running the risk of being declared delinquent or being placed under probation in terms of section 162 of the Companies Act 2008 for failing to adhere to the concerns that the Auditor-General

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[67] Naudé et al *Business Perspectives on the Steinhoff Saga* (2018) University of Stellenbosch Business School Special Report 2.

[68] Rabkin F 'Steinhoff relies on legal "fig leaf"' *Mail & Guardian* 08 November 2019 available at https://mg.co.za/article/2019-11-08-00-steinhoff-relies-on-legal-fig-leaf/ (accessed on 02 March 2021).

[69] Gernetzky K 'Deloitte makes R1bn move to clean its Steinhoff stain' *Business Day* 15 February 2021 available at https://www.businesslive.co.za/bd/companies/retail-and-consumer/deloitte-makes-r1bn-move-to-clean-its-steinhoff-stain/ (accessed on 02 March 2021).

[70] Naudé et al (2018) 2.

[71] See *Key Findings of the PwC Investigation Report* (2019) available at https://www.tongaat.com/wp-content/uploads/2019/11/Key-findings-of-PwC-Investigations-29-Nov-2019.pdf (accessed on 09 September 2020).

[72] See McKane J 'Major corruption unearthed at EOH' *mybroadband* 16 July 2019 available at https://mybroadband.co.za/news/business/313465-major-corruption-unearthed-at-eoh.html (accessed on 03 September 2020).

had raised in their respective annual financial reports.[73] The SAA has recently concluded a business rescue process and the erstwhile chairperson of its board of directors was declared a delinquent director by the court.[74] Transnet and Eskom were subject of crucial testimony at the Judicial Commission of Inquiry into Allegations of State Capture, Corruption and Fraud in Public Sector including Organs of State ('Zondo Commission').[75] Among many others, these big corporations have encountered grave governance transgressions which have adversely affected the shareholders, creditors, employees and the communities in general, among other stakeholders. This happened despite the fact that these corporations and public entities have or had audit committees whose statutory duties include, among other things, addressing concerns and complaints relating to the companies' accounting practices and internal financial controls,[76] as well as performance of other oversight functions as may be determined by the corporations' board of directors and governing bodies.[77]

Despite the audit committees' stewardship role in respect of the audit function, the widely reported failings of the corporations' auditors continue to be of grave governance concern. For example, the shareholders of African Bank Investments Limited ('ABIL'), which is listed on the Johannesburg Securities Exchange Limited ('the JSE'), instituted a claim for damages against the directors of that company and its auditor, Deloitte.[78] The claim was based on the damage allegedly suffered by the shareholders as a result of the diminution in the value of their shares in ABIL.[79] The shareholders argued that Deloitte was tasked by ABIL to audit and report on the financial standing of ABIL and its wholly owned subsidiary company, African Bank

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[73] Also see Thabane T & Snyman-Van Deventer E 'Pathological Corporate Governance Deficiencies in South Africa's State-Owned Companies: A Critical Reflection' (2018) 21 *PER/PELJ* 5. Also see the CIPC Media Statement no 2 of 2014 available at http://www.cipc.co.za/files/6514/1933/0901/Media_Statement_2_of_2014.pdf, (accessed on 09 September 2020).

[74] See *Organisation Undoing Tax Abuse and Another v Myeni and Other* (15996/2017) [2020] ZAGPPHC 169 (27 May 2020) para 285.

[75] Judicial Commission of Inquiry into allegations of State Capture, Corruption and Fraud in public sector including organs of State, proclamation no 3 of 2018, published in Government Gazette no 41403, 25 January 2018.

[76] S 94(7)(g) of the Companies Act 2008.

[77] S 94(7)(i) of the Companies Act 2008.

[78] *Hlumisa Investment Holdings (RF) Ltd and Another v Kirkinis and Others* (1423/2018) [2020] ZASCA 83 (03 July 2020).

[79] *Hlumisa Investment Holdings (RF) Ltd and Another v Kirkinis and Others* (1423/2018) [2020] ZASCA 83 (03 July 2020) para 3.

Limited ('African Bank'). They further argued that Deloitte had reported that African Bank's annual financial statements fairly presented that Bank's financial position.[80] Although the claim has failed,[81] it demonstrates the failures of the audit function under the stewardship of the audit committee.

The KPMG[82] scandal provides another example of failings of the auditing function despite the existence of the audit committee in these corporations. This audit firm is currently being sued by the liquidators of one of its former clients, the VBS Mutual Bank ('VBS Bank'), for an amount in excess of R800 million. This claim is based on the firm's alleged failure, as the VBS Bank's auditor, to report on the financial irregularities and alleged corruption within the VBS Bank.[83] The auditor's alleged failure to report the financial irregularities and alleged corruption happened under the stewardship of its audit committee. It is said that the scandals of both the African Bank and VBS Bank 'revealed similar causes of the collapses, namely corporate governance failures; poor or corrupt corporate practices; reckless lending in one case and reckless conducting of the business of banking in both [cases]'.[84]

1.3 PROBLEM STATEMENT

The financial scandals briefly highlighted above[85] represent a serious indictment on the auditing profession in South Africa generally and the effectiveness of the audit committee in particular. The audit committee is an important corporate governance instrument and its independence is seen as the cornerstone of its efficacy.[86] The

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[80] *Hlumisa Investment Holdings (RF) Ltd and Another v Kirkinis and Others* (1423/2018) [2020] ZASCA 83 (03 July 2020) para 7.
[81] *Hlumisa Investment Holdings (RF) Ltd and Another v Kirkinis and Others* (1423/2018) [2020] ZASCA 83 (03 July 2020) para 74.
[82] KPMG is one of the big accounting and audit firms globally.
[83] See Koko K 'In a bizarre twist VBS liquidators sue KPMG for R863mn' *Mail & Guardian* 24 February 2021 available at https://mg.co.za/business/2021-02-24-in-a-bizarre-twist-vbs-liquidators-sue-kpmg-for-r863mn/ (accessed 02 March 2021).
[84] Mupangavanhu BM 'Banking Crises in South Africa: Some Lessons for Corporate Governance and the Regulation of Banks' (2021) 35.
[85] See the discussion in point 1.2 above.
[86] Chariri A & Januarti I 'Audit Committee Characteristics and Integrated Reporting: Empirical Study of Companies Listed on the Johannesburg Stock Exchange' (2017) vol XX issue 4B *European Research Studies Journal* 308-309; Also see Marx B (2008) 338.

independence of the audit committee in South African corporations is contemplated in the country's company legislation[87] and corporate governance code.[88]

It is not suggested that an independent and effective audit committee could completely root out corporate governance failures and financial irregularities scandals in South Africa or anywhere in the world. However, when these corporate governance failures which are characterised by non-compliance, fraudulent financial reporting, creative accounting and auditor inefficiency happen, the effectiveness of the audit committee will be in doubt. Closely related to the question of the effectiveness of the audit committee is the question of the committee's independence and the protection of that independence. This is premised on the fact that a fundamental feature of an effective audit committee is that committee's independence.[89]

The independence of the audit committee under the Companies Act 2008 is not sufficiently protected and this is premised on a number of factors, including:

- that the board of directors of the company has the powers to appoint and remove members of the company's audit committee;[90]
- that the general consensus among corporate governance authors appears to be that the audit committee is a subcommittee of the company's board of directors. However, while it may be argued that the audit committee under the Companies Act 2008 is a committee of the company's board and accountable to the board,[91] it is argued in this thesis that the audit committee is not a committee of the board of directors and further that it should not be accountable to the board of directors;
- that only directors of the company can be appointed on and serve as members of the company's audit committee[92] and

[87] In terms of s 94(4)(b) of the Companies Act 2008.
[88] See recommended practice 51 under Principle 8 of *King IV Code*.
[89] Global Institute of Internal Auditors *Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations* (2014) 12.
[90] S 94(3)(b) and s 94(6) of the Companies Act 2008.
[91] Cassim et al *Contemporary Company Law* 3 ed (2021) 625.
[92] S 94(4)(a) of the Companies Act 2008.

- that the appointment of the audit committee does not reduce the board of directors' overall statutory functions and duties in respect of the management of the business and affairs of the company.[93]

For public entities, the chairperson of the entity's audit committee must report to the relevant executive authority and the Auditor-General of South Africa any information which implicates any or all members of the accounting authority in fraud, corruption or gross negligence.[94] The executive authority means the National or Provincial Minister under whose portfolio the public entity falls.[95] The problem with this arrangement is that members of the public entities' audit committees and the relevant chairpersons are appointed by, account to and can be removed by the accounting authorities[96] whose conduct may be subject to the reporting contemplated in Regulation 27.1.11 of the Treasury Regulations for PFMA. Section 1, read with section 49 of the PFMA, defines an 'accounting authority' of a public entity as the board or controlling body or in cases where the public entity does not have a controlling body, the accounting authority is the entity's Chief Executive Officer ('CEO') or any other person in charge of the entity, unless a specific legislation applicable to that public entity dictates otherwise. The fact that the audit committee of a public entity must be appointed by the entity's board of directors or even its CEO exposes such committee to the risk of undesirable influence and interference by the accounting authority that appointed it, thus undermining the audit committee's independence.

From the above exposition, the common lacuna under both the Companies Act 2008 and the PFMA, including the relevant regulations, is that the audit committee of companies in the private sector and public entities is not sufficiently protected under these pieces of legislation. This makes it possible and quite easy for the independence of audit committees to be eroded by the governing bodies of private owned companies and public entities. Cassim *et al* observes that 'in recent years, a series of highly publicised corporate scandals and high profile corporate failures worldwide have prompted the further development of corporate

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[93] S 94(10) of the Companies Act 2008.
[94] Regulation 27.1.11 of the Treasury Regulation for PFMA.
[95] S 1 of the Public Finance Management Act 1 of 1999.
[96] Regulation 27.1.1 of the Treasury Regulation for PFMA.

governance principles and practices, and have highlighted the lack of effective accountability within companies'.[97] As the audit committee is seen as an important mechanism in corporate governance,[98] this study contributes to the possible development and/or reform of corporate governance through enhancement of the protection of the independence of the audit committees of companies.

The independence of the audit committee and protection thereof are necessary for effective functioning of the committee to, among other things, (a) improve the integrity and quality of financial reporting, (b) strengthen the committee's oversight function, (c) enhance the auditor's independence, (d) enforce regulatory and legislative compliance, and (e) promote sound corporate governance for the benefit of the community of stakeholders. It is submitted that if the identified weaknesses on the protection of the independence of the audit committee under the Companies Act 2008 and the PFMA are not resolved, the corporate governance failures in general and financial irregularities scandals in particular would continue to deteriorate.[99] This assertion is based on the observation that, despite the application of provisions of section 76 (Standards of directors conduct) and section 77 (Liability of directors and prescribed officers) of the Companies Act 2008, governing bodies of privately-owned companies and SOEs have not appeared to be discouraged from engaging in activities which have had the effect of hurting the companies and their communities of stakeholders. An increased protection of the independence of the audit committee would give the committee more incentive to execute its oversight function without fear or favour and help to improve corporate transparency and accountability for the benefit of all stakeholders.

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[97] Cassim et al *Contemporary Company Law* 3 ed (2021) 642.

[98] van der Nest DP, Thornhill C & de Jager J 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 549.

[99] However, this is not to suggest that all corporate governance failures and financial reporting scandals in South Africa occur as a result of lack of independence (and protection thereof) of the company's audit committee. Some of these corporate scandals flow from lack of an effective consequence management and shareholder apathy.

1.4 RESEARCH QUESTION AND OBJECTIVES

The central research question which this thesis answers is whether the independence of the audit committee of privately-owned companies and SOEs is adequately protected under the Companies Act 2008 and the PFMA.

To investigate the abovementioned key research question, the following sub-questions are investigated:

- Does the fact that the audit committee under the Companies Act 2008 must comprise at least three directors, even if those directors must be independent directors of the corporation, not diminish the independence of the audit committee?
- It will be canvassed in this thesis that the idea behind the independence of audit committees is not only to safeguard such committees from the interference and undue influence by the corporations' management but also from the board of directors and accounting authorities. For this reason, the question to be considered is: what is the purpose of having members of the corporations' governing bodies on the corporations' audit committee?
- By virtue of having the appointing powers, do governing bodies of corporation and public entities have the analogous powers to remove members from the audit committee?[100]
- Though they must not constitute the majority, persons under the employ of the public entities may be appointed to the entities' audit committees. Does this not have the effect of compromising the independence of the audit committees of these entities?
- What are the theoretical underpinnings (theoretical foundations and perhaps motivations) for the independence of the audit committee?

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[100] In *Masetlha v President of the Republic of South Africa and Another* 2008 (1) SA 566 (CC) para 68, the Constitutional Court, dealing with the powers of the President, held that the power to dismiss is an essential corollary of the power to appoint and the power to dismiss must be read into section 209(2) of the Constitution. The finding in *Masetlha* was further cited in *MEC: Free State Provincial Government: Tourism, Economic and Environmental Affairs v Moeko and Others* (JR 2582/07) [2013] ZALCJHB 15; (2013) 34 ILJ 2256 (LC) (8 February 2013) para 35 and more recently in *South African Broadcasting Corporation (Soc) Ltd v Keevy and Others* (J1652-19) [2020] ZALCJHB 31 (7 February 2020) para 49.

- What should be the place of an audit committee within the corporate structure?
- What are the international experiences with the independence of the audit committees, and are there any international best practices that South Africa can learn from?

The objective of this study is to compellingly advance an argument and demonstrate that the legislative provisions dealing with the independence of the audit committee under the Companies Act 2008 and the PFMA are riddled with weaknesses, which give the governing bodies of corporations and public entities latitude to interfere with the functioning and independence of audit committees. This thesis contributes to literature and the general body of knowledge in the domain of corporate governance, and stimulate further possible studies to develop the field of the audit committee as an important governance mechanism to promote transparency and accountability within South African corporations.

1.5 JUSTIFICATION OF THE STUDY

This segment provides a brief evaluation of the material by leading authors in the realm of the independence of the audit committee and the protection thereof. It further highlights gaps in the current body of knowledge, which necessitated this study.

As van der Nest *et al* point out, the audit committee is seen as an important mechanism in corporate governance.[101] It is increasingly regarded as an integral part of modern control structures and governance practices in both the private and public sectors.[102] Throughout its existence, the concept of audit committee has been accepted as key component of the corporate governance structure of entities.[103] Marx and van der Watt further remark that an effectively functioning audit committee

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[101] van der Nest DP, Thornhill C & de Jager J 'Audit committee and accountability in the South African Public Sector' (2008) Vol 43 (4) *Journal of Public Administration* 549.

[102] van der Nest DP 'The perceived effectiveness of audit committees in the South African public service' (2008) 16 (2) *Meditari Accountancy Research* 175-176.

[103] Marx B & van der Watt A 'Sustainability and integrated Reporting: An analysis of the audit committee's oversight role' (2011) 9 (2) *Journal for New Generation Sciences* 57.

can play an important role in assisting the board of directors of companies in providing accurate and credible integrated reporting of its financial performance and sustainability.[104] The role of the audit committee also includes an oversight responsibility on behalf of the board of directors for ensuring that the company provides accurate, reliable and credible financial and non-financial information to the stakeholders.[105] Turley and Zaman express the view that audit committees are expected to monitor the reliability of the company's accounting processes and compliance with corporate legal and ethical standards, including the maintenance of preventive fraud controls.[106]

Marx and van der Watt further highlight the need for the audit committee to function as a subcommittee of the board of directors.[107] However, Delport, on his commentary on the Companies Act 71 of 2008, seems to disagree and holds the view that the audit committee is not a committee of the board of directors.[108] This view is supported by Hendrikse and Hefer.[109] Without expressing any opinion on what the reasons could be, Marx and van der Watt concluded that the majority of audit committees at the largest listed companies in South Africa are not taking oversight responsibility for sustainable reporting on the board's behalf, although, they are dealing with some ethical and social reporting aspects.[110] A case is being made out in this study that the audit committee's failure in its oversight role is directly linked to an inadequate protection of its independence.

There is general convergence among authors, that the members of the audit committee must be independent non-executive members of the corporation's board of directors as prescribed by the Companies Act 2008.[111] However, the court warned us, that it is unhelpful or even misleading to classify company directors as executive or non-executive for purposes of ascertaining their duties to the company.[112] No

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[104] Marx B & van der Watt A (2011) 58.
[105] Marx B & van der Watt A (2011) 61.
[106] Turley S & Zaman M 'The Corporate Governance Effects of Audit Committees' (2004) 8 *Journal of Management and Governance* 309.
[107] Marx B & van der Watt A (2011) 61.
[108] Delport P *Henochsberg's Commentary on the Companies Act 71 of 2008* (2017) 356.
[109] Hendrikse JW & Hefer L (2019) 389-390.
[110] Marx B & van der Watt A (2011) 66.
[111] S 94(4) of the Companies Act 2008.
[112] *Howard v Herrigel & Another NNO* (1991) (2) SA 660 (A) 676.

such distinction is to be found in any statute.[113] As it is canvassed in this thesis, it is indeed irrelevant whether members of the audit committee of a company are classified as executive or non-executive directors as their responsibility towards the company remains the same. Further, the Companies Act 2008 does not distinguish between executive or non-executive directors for the purpose of directors' liability under that Act. In this respect, it is shown that the fact that members of the audit committee must be independent non-executive directors of the company does very little to promote and protect the independence of the audit committee.

While a great deal of work has been done around the concept of the audit committee, literature focusing specifically on the protection of the independence of the audit committee in South African corporate structures through the application of the Companies Act 2008 and the PFMA could not be found. The academic authors have, in the main, dealt with the composition, role, functions and a particular emphasis is placed on the importance and effectiveness of the audit committee in both private and public entities. Morgan does not deal with the question of protection of the independence of the audit committee but recommends that the performance of members of the audit committee could be improved and enhanced by regular assessments.[114] Akwenye, Chata and Benedict highlight one of the challenges faced by public sector audit committees and comment thus: 'the independence of the audit committee may be impaired due to previous and/or current relationships of audit committee members or the audit committee as a whole and political standing, among other factors'.[115] The learned authors suggest that audit committees of SOEs face an increased political exposure, which may affect the committees' independence. This research project expands on this and many other challenges.

The following books by leading South African corporate and commercial law authors were also reviewed in so far as they discuss the system of audit committee within corporate structures: Davis *et al Companies and other business structures in South*

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[113] *Howard v Herrigel & Another NNO* (1991) (2) SA 660 (A) 676.
[114] Morgan I 'A formalised performance assessment process to improve audit committee performance in South Africa: a conceptual exploration' (2010) 14 (2) *Southern African Business Review* 110.
[115] Akwenye NJ, Chata T & Benedict OH (2016) 286.

Africa (Oxford 2008), Delport P *New Entrepreneurial Law* 2 ed (LexisNexis 2021), Cassim *et al Contemporary Company Law* 3 ed (Juta 2021), Hendrikse JW and Hefer L *Corporate Governance Handbook: Principle and Practice* 3 ed (Juta 2019) and Cassim *et al The Law of Business Structures* 2 ed (Juta 2021). These books are, with respect, disappointingly descriptive and lack the necessary detailed and critical analysis of the independence (and the protection thereof) of the audit committee under the Companies Act 2008. The reason for this may be that the learned authors did not regard the independence of the audit committee as significant and worthy of any protection. This is the grey area which this study explores.

1.6 METHODOLOGY

This research project employs theoretical desktop methodology with components of qualitative, legislative, literature and case law review. It includes a comparative study to draw parallels between the South African position and positions in selected foreign jurisdictions. In particular, the comparative analysis covers the United States of America and the United Kingdom jurisdictions based on the following justification:

- United States of America ('USA'): The corporate governance scandals and financial reporting irregularities in the USA have led to promulgation of SOX Act in that country. The purpose of this comparison is to gauge the level of independence of the audit committee of American corporations and how such independence is protected under the SOX Act.
- United Kingdom ('UK'): The South African company law has a rich English law heritage, and the enduring influence of English law dates back to the middle of the nineteenth century and the previous framework (under the Companies Act 46 of 1926 and later under the Companies Act 1973), and to some extent the current Companies Act 2008, is founded upon the principles of English company law.[116] The purpose of this comparison is to measure

[116] South African Company Law for the 21st Century, Guidelines for Corporate Law Reform (GN 1183 in GG 26493 of 23 June 2004) 12. Also see Botha MM 'The role and duties of directors in the promotion of corporate governance: A South African Perspective' (2009) *Obiter* 704.

how the UK company law jurisprudence deals with the independence of the audit committee and whether or not any lessons may be drawn from that jurisdiction.

Various primary and secondary data sources were consulted and analysed. Data was collected from all available media such as books, journals, articles, published theses, cases, legislation, regulations, reports and other relevant and credible sources, including internet sources. Central to this research are the provisions of the Companies Act 2008, the Company Regulations 2011, the PFMA and the Treasury Regulations for PFMA.

This study uses the referencing and house style of the Faculty of Law, University of the Western Cape.

1.7 SCOPE AND LIMITATIONS

This research paper only examines the relevant provisions dealing with the composition, appointment, removal and the functions of the audit committees of private-owned corporations under the Companies Act 2008 and large public entities under the PFMA. This paper makes the argument that the independence of the audit committee, as an organ of the company, is not protected, thus making it susceptible to interference by the companies' board of directors and public entities' accounting authorities.

The independence of the audit committee in the government and state departments, as well as municipalities and municipal owned entities, falls outside the scope of this thesis. Thus, the relevant provisions governing the audit committee under the Local Government: Municipal Systems Act 56 of 2003 are not considered in this study.

1.8 CHAPTER OUTLINE

The structure of this thesis takes the following shape:

Chapter 1: This introductory section entails the background, problem statement, the purpose and objectives, the main research question and sub-questions. The problem statement out of which the research questions flow, is located within the context of the auditing of companies' financial statements and the general financial reporting in terms of the Companies Act 2008 and the PFMA and the relevant regulations. A brief overview of the legislative requirements for auditing of financial statements is also given in this chapter. This chapter also provides the scope and limitations of this research, as well as the chapter outline.

Chapter 2: This chapter focuses on the company law concepts as they relate to the independence, function and role of the audit committee within the corporate structure. As the audit committee plays a pivotal role in corporate governance, this chapter begins with the conceptualisation of the meaning of corporate governance. This is followed by analysis of the definition of a director of the company and powers and duties of the board of directors. The chapter also deals with the rights and duties of the shareholders. It further analyses the concepts of executive and accounting authority of public entities and concludes by evaluating the relationships between the audit committee and the company and its community of key stakeholders.

The following is a list of sub-topics covered in this chapter:

- The concept of corporate governance;
- Board of directors as the organ of the company;
- The Powers, duties of directors and the relationship between the company and its directors;
- Shareholders as the organ of the company;
- Rights and powers of shareholders;
- Corporate governance under the PFMA;
- Accounting authority;
- Executive authority;
- Audit committee and corporate governance and
- The relationships between the audit committee and the company and its community of key stakeholders.

Chapter 3: This chapter discusses the constitution, appointment and the removal of the members of audit committee under the Companies Act 2008 and the PFMA. It is demonstrated in this chapter that the composition, appointment and the removal of members of the audit committee have a direct effect on the independence of that committee and protection thereof. Further, the role, functions and duties of the audit committee are critically evaluated in this chapter. The purpose is to demonstrate that the audit committee plays crucial governance compliance, financial reporting oversight, assurance and advisory roles in South African corporations and public entities and how its independence is the cornerstone.

Chapter 4: The overall objective of this chapter is to juxtapose the South African position in respect of the independence of audit committees with the position in some foreign jurisdictions. This comparison covers the USA and the UK jurisdictions. The justification for choosing the USA and the UK jurisdictions is set out in 1.6 above.

Chapter 5: The entire chapter five is dedicated to an in-depth critical evaluation of the independence of the audit committees under South African business framework in both private and public entities, with particular reference to the Companies Act 2008 and the PFMA. It is further demonstrated how such independence is not adequately protected from possible interference and undue influence by the corporations' board of directors and accounting authorities. The sub-topics which are discussed in this chapter are:

- The meaning of the term 'independence' within the context of the audit committee;
- The protection of the independence of the audit committee under the Companies Act 2008;
- The protection of the independence of the audit committee under the PFMA;
- Does the director's individual independent judgment promote and protect the independence of the audit committee?
- Personal liability of members of the audit committee; and
- Does the audit committee need an absolute independence and protection?

Chapter 6: This chapter concludes this study and provides workable recommendations.

CHAPTER 2: THEORETICAL UNDERPINNINGS FOR THE INDEPENDENCE OF THE AUDIT COMMITTEE WITHIN THE CORPORATE STRUCTURE

2.1 INTRODUCTION

One of the purposes of the Companies Act 2008 relevant to this chapter and the thesis as stated in section 7(b)(iii) of the Companies Act 2008 is 'to promote the development of the South African economy by - encouraging transparency and high standards of corporate governance as appropriate, given the significant role of enterprises within the social and economic life of the nation'. Promotion of accountability and transparency, which are fundamental features of high standards of corporate governance, form the centerpiece of this study. It is for this reason that the critical roles of directors and shareholders, as the two main organs of the company[117] and the embodiment of corporate governance within the company, are discussed in this chapter.

If the concept of corporate governance is to be regarded as a mechanism to hold companies accountable to both the shareholders and other stakeholders, the audit committee should be seen as the cornerstone of the corporate structure[118] and key feature of corporate governance. As the field of corporate governance is vast, this chapter is limited to the discussion of directors and shareholders as key drivers of the culture of corporate governance in the company, because it is within these two organs of the company where corporate governance, fiduciary duties and the shareholders' rights lie.[119] The chapter begins with the conceptualisation of the meaning of corporate governance, followed by an analysis of the definition of a director of the company and directors powers and duties. This chapter also introduces the rights and duties of the shareholders, as well as the shareholders' relationship with the company, and further evaluate the concepts of executive and accounting authority of public entities.

Further, this chapter examines the institution of audit committee with the intention to establish whether the audit committee is a subcommittee of the company's board

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[117] Cassim et al *Contemporary Company Law* 3 ed (2021) 467.
[118] Marx B (2008) 338.
[119] Esser I & Havenga M 'Shareholder participation in corporate governance' (2008) 22(1) *Speculum Juris* 74.

of directors or that it is, in fact or supposed to be, a standalone organ of the company. The discussion then proceeds to evaluate the relationship between the audit committee and the corporations' governing bodies, namely the board of directors of privately-owned companies and accounting authorities of public entities. This analysis does not only demonstrate the need for an appropriate protection of the audit committee but also from whom such protection is essential. To conceptualise how the protection of the audit committee should be, this chapter further reflects on the relationship between the audit committee and the shareholders of privately-owned companies and executive authorities of public entities, as well as creditors. The chapter concludes with a discussion of the relationship between the audit committee and the company's auditors.

The purpose of this chapter is to lay down a theoretical foundation underpinning the independence of the audit committee and how the audit committee fits within the system of corporate governance. This chapter demonstrates the significance of the institution of the audit committee in relation to the company and its various stakeholders. After discussion of these key concepts and the relevant relationships between the audit committee and the company and its key stakeholders in this chapter, it will become clear how these underpinnings may strengthen or weaken the protection of the independence of the company audit committees. The reader will further be armed with the necessary conceptual background of the critical role which the organs of the company, namely directors and shareholders, play in the life and functioning of the company's audit committee and its independence. At the conclusion of this chapter, it will become clear that, in light of these relationships, a concrete protection of the independence of the company's audit committee is not only necessary to enhance the committee's effectiveness but also vital to improve the overall system of corporate governance in the interest of the company's broader stakeholder community and the society at large.

2.2 CORPORATE GOVERNANCE

2.2.1 The concept of corporate governance

Although the practice of sound corporate governance has been hailed as essential for the well-being of companies,[120] there has not been a single all-inclusive definition of the concept of corporate governance. This concept is differently defined.[121] It involves an intersection of often competing multi-stakeholder interests, and thus by its very nature, is laden with tensions.[122] While there may not be a universally agreed upon definition of corporate governance, there are shared fundamentals regarding how directors are expected to carry out their responsibilities in a company.[123] Although defined differently, corporate governance is essentially understood to be about effective and responsible leadership,[124] expected from directors of the company. Responsible leadership is characterised by the ethical values of responsibility, accountability, fairness and transparency, which values underpin good corporate governance.[125]

The Cadbury Report[126] defines corporate governance as a ‘system by which companies are directed and controlled’.[127] This definition is cited, with approval, by many corporate law writers.[128] It is about openness, integrity and accountability.[129] The requirement of integrity in corporate governance was espoused in *South African*

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[120] *Minister of Water Affairs and Forestry v Stilfontein Gold Mining* 2006 (5) SA 333 (W) para 16.7; Cassim et al *Contemporary Company Law* 3 ed (2021) at 643; Cassim et al *The Law of Business Structures* 2 ed (2021) 324.

[121] Esser I & Havenga M ‘Shareholder participation in corporate governance’ (2008) 22(1) *Speculum Juris* 74. Botha MM ‘The role and duties of directors in the promotion of corporate governance: A South African perspective’ (2009) 30(3) *Obiter* 703.

[122] Mupangavanhu BM *Directors’ standards of care, skill, diligence, and the business judgment rule in view of South Africa’s Companies Act 71 of 2008: Future complications for corporate governance* (published PhD thesis, University of Cape Town 2016) 17.

[123] Mupangavanhu BM (2016) 18.

[124] Cassim et al *Contemporary Company Law* 2 ed (2012) 473.

[125] Cassim et al *Contemporary Company Law* 2 ed (2012) 473.

[126] *Report of the Committee on The Financial Aspects of Corporate Governance* (the Cadbury Report), (published on 1 December 1992, Gee and Co. Ltd); Also see Bhasin M 'Strengthening corporate governance through an audit committee: An empirical study' (2016) vol 23 no. 2 *Wulfenia Journal* 3.

[127] See *Cadbury Report* (1992) para 2.5.

[128] See Cassim et al *Contemporary Company Law* 3 ed (2021) 642; Bhasin M 'Strengthening corporate governance through an audit committee: An empirical study' (2016) vol 23 no. 2 *Wulfenia Journal* 3; Marx B (2008) 10; Mupangavanhu BM (2016) 18.

[129] Bhasin M (2016) 3.

Broadcasting Corporation v Mpofu.[130] In this case, the court made the following important remark:

> Integrity is a key principle underpinning good corporate governance. Put clearly, good corporate governance is based on a clear code of ethical behaviour and personal integrity exercised by the board, where communications are shared openly.[131]

The court in *Mthimunye-Bakoro v Petroleum Oil and Gas Corporation of South Africa (SOC) Limited and Another*[132] defined corporate governance as the animating idea of which is to ensure net gains in wealth for shareholders, protect the legitimate concerns of other stakeholders and improve efficiency, organisational performance and resource allocation.[133]

The *King IV Report*[134] defines corporate governance as 'the exercise of ethical and effective leadership by the governing body towards the achievement of the following governance outcomes: ethical culture, good performance, effective control and legitimacy'. Embedded in the *King IV Report* is the *King IV Code*[135], which lists recommended corporate governance principles which South African corporations are encouraged to comply with. It must be noted that the *King IV Code* is a voluntary[136] code, except for corporations which are listed on the JSE[137] and public entities.[138]

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[130] (A5021/08) [2009] ZAGPJHC 25; [2009] 4 All SA 169 (GSJ) (11 June 2009).

[131] *South African Broadcasting Corporation v Mpofu* (A5021/08) [2009] ZAGPJHC 25; [2009] 4 All SA 169 (GSJ) (11 June 2009) para 64; Also see Cassim et al *The Law of Business Structures* 2 ed (2021) 327, where it is stated that 'in order to offer effective leadership that results in achieving strategic objectives and positive outcomes, the board members should, individually and collectively, embody the following ethical characteristics: integrity, competence, responsibility, accountability, fairness and transparency'.

[132] (12476/2015) [2015] ZAWCHC 113; 2015 (6) SA 338 (WCC) (4 August 2015).

[133] *Mthimunye-Bakoro v Petroleum Oil and Gas Corporation of South Africa (SOC) Limited and Another* (12476/2015) [2015] ZAWCHC 113; 2015 (6) SA 338 (WCC) (4 August 2015) para 20.

[134] Institute of Directors in South Africa 'King IV: Report on Corporate Governance in South Africa' (2016) (*King IV Report*).

[135] Part 5 of the *King IV Report* (2016).

[136] *King IV Report* (2016) 35, where the Report sets its legal status as 'that of a set of voluntary principles and leading practices'.

[137] See section 8.63(a) of the Johannesburg Stock Exchange Listing Requirements available at https://www.jse.co.za/content/JSERulesPoliciesandRegulationItems/JSE%20Listings%20Requirements.pdf (accessed on 5 May 2020).

[138] See *South African Broadcasting Corporation v Mpofu* para 29, where the court remarked that the conduct of public enterprises must be measured against the relevant principles of the code and must adhere to best practices.

Having examined the various definitions, and in an effort to contribute to the development of the definition of corporate governance, it is submitted that the concept should also be further defined from the perspective of legislative and regulatory compliance. The reason for this is that, compliance with rules of governance is a necessity.[139] There is always a link between good governance and compliance with law.[140] Although compliance with the *King IV Code* is voluntary for non-listed companies,[141] the Companies Act 2008 and the relevant Companies Regulations 2011 require mandatory compliance from all companies to which that Act and regulations apply. It has been argued that, for boards of directors[142] of companies, non-compliance with the principles embedded in the *King IV Report* may amount to negligence and breach of their duties of care and skill.[143] This also applies to non-compliance with other pieces of legislation applicable to the company.[144]

The term corporate governance can, therefore, be further defined as: a commitment, by corporate leadership, to the culture of compliance with the legislative and regulatory framework, as well as best practices governing corporations (own definition). It is this compliance with the relevant legislative and regulatory guidelines that highlights high levels of ethical behaviour and integrity, fairness and transparency, responsiveness and accountability as highlighted by various authors discussed above. It is submitted that compliance with the applicable legislative and regulatory rules and best practices 'regulates the conduct of those in control of the corporation'[145] in the interest of all stakeholders. As noted in the Cadbury Report, while structures and rules provide the necessary framework to encourage and

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[139] Charan R *Boards That Deliver: Advancing Corporate Governance From Compliance To Competitive Advantage* (John Wiley & Sons 2011) 22.

[140] Muswaka L 'Shielding Directors against Liability Imputations: The Business Judgment Rule and Good Corporate Governance' (2013) 1 *Speculum Juris* 25.

[141] See *King IV Report* (2016) 35.

[142] See *South African Broadcasting Corporation v Mpofu* para 9, where the court observed that the Board in its entirety is the principal focal point of good corporate governance.

[143] See *Minister of Water Affairs and Forestry v Stilfontein Gold Mining* 2006 (5) SA 333 (W) para 16.7; Also see Esser I & Delport P 'The protection of stakeholders: The South African social and ethics committee and the United Kingdom's enlightened shareholder value approach: Part 1' (2017) *De Jure* 97-110 footnote 5.

[144] *Unica Iron & Steel (Pty) Ltd v Mirchandani; Mirchandani v Unica Iron & Steel (Pty) Ltd* (3494/2014, 85824/2014, 51538/2014) [2020] ZAGPPHC 115 (3 March 2020) para 64, where the court held that a director failed to act in the best interests of the company through the company's non-compliance in circumstances where the director was aware or knew that environmental legislation had to be complied with.

[145] Botha MM 'The role and duties of directors in the promotion of corporate governance: A south African perspective' (2009) 30(3) *Obiter* 704.

support good governance, they, alone, are not enough to achieve high standards of corporate governance. What counts is compliance.[146] The *King IV Report* not only requires corporations to *apply* the principles of corporate governance but also to demonstrate that good governance is being practised.[147] The requirement for explanation of how good governance is being practised guides stakeholders to make an informed decision as to whether or not the corporation is achieving principles of ethical culture, good performance, effective control, and legitimacy.[148]

2.2.2 The board of directors as an organ of the company

2.2.2.1 Directors and corporate governance

Boards of directors are responsible for corporate governance of their companies.[149] The courts have played their role in accentuating the centrality of corporate governance, as being the accountability of senior management and the boards of companies because of the extensive powers vested therein.[150] It is the board of directors in its entirety that is the principal focal point of good corporate governance.[151] It has a collective responsibility to provide effective corporate governance and should exercise leadership, enterprise, integrity and judgment in directing the company.[152] For this reason, it becomes important to identify the directors of the company, to establish who is responsible and accountable for the management and direction of the affairs of the company[153] and adherence to corporate governance legislative framework and regulatory codes.[154]

Although the Companies Act 2008 does not define the phrase 'board of directors', it defines a 'director' as a member of the board of a company, as contemplated in

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[146] *Cadbury Report* (1992) para 3.13.
[147] See *King IV Report* (2016) 7.
[148] See *King IV Report* (2016) 7.
[149] See *Cadbury Report* (1992) para 2.5.
[150] See *Mthimunye-Bakoro v Petroleum Oil and Gas Corporation of South Africa (SOC) Limited and Another* (12476/2015) [2015] ZAWCHC 113; 2015 (6) SA 338 (WCC) (4 August 2015) para 5; *South African Broadcasting Corporation v Mpofu* para 28.
[151] *South African Broadcasting Corporation v Mpofu* para 9. Also see Principle 6 under Part 5.3 of the *King IV Code*.
[152] *South African Broadcasting Corporation v Mpofu* para 30.
[153] Cassim et al *The Law of Business Structures* 2 ed (2021) 274.
[154] See Cassim et al *Contemporary Company Law* 3 ed (2021) 540, where it is stated that 'higher standards are continually being expected of directors, as evidenced in the Act, the *King IV Report* (2016) and the *King IV Code*'.

section 66.[155] Section 66 of the Companies Act 2008 makes provision for minimum number of directors required to make up a board of directors for different types of companies,[156] and further allows the company to alter the requirement for minimum number of directors to a high number.[157] The definition of a director also includes an alternate director of a company and any person occupying the position of a director or alternate director, by whatever name designated.[158] This suggests that a director is not only a member of the company's board of directors but also persons such as *de facto* directors who are not formally appointed as directors[159] and anyone who acts in the position of a director with or without lawful authority.[160] The phrase 'whatever name designated' in the definition of a director means that the title or description of a position is not relevant in determining whether a person is a director.[161]

It is clear that the board of directors of the company consists of directors only.[162] It is also clear from the definition of the term 'director' that there may be directors of the company who do not sit on the company's board of directors. Despite the fact that all directors of the company owe their common law fiduciary duties to the company,[163] and that all directors are subject to the same standards of conduct,[164] and directors' liability,[165] and that all directors are individually and collectively accountable to the company,[166] the definition of director in section 1 of the

[155] S 1 of the Companies Act 2008.
[156] S 66(2) of the Companies Act 2008.
[157] S 66(3) of the Companies Act 2008. While the minimum required number of directors may be increased through the company's MOI, it must be noted that the Companies Act 2008 makes no provision for the maximum number of directors required to make up the board of directors of the company. This may also be regulated through the company's MOI.
[158] S 1 of the Companies Act 2008.
[159] Cassim et al *Contemporary Company Law* 3 ed (2021) 541.
[160] Cassim et al *Contemporary Company Law* 3 ed (2021) 541. Also see *Corporate Affairs Commission v Drydale* (1978) 141 CLR 236.
[161] Cassim et al *The Law of Business Structures* 2 ed (2021) 275.
[162] S 66(2) of the Companies Act 2008.
[163] *Cohen v Segal* 1970 (3) SA 702 (W) 706; *Fisheries Development Corporation of SA Ltd v Jorgensen and Another* 1980 (4) SA 156 (T) 163D-G; *Barlows Manufacturing Co Ltd v RN Barrries (Pty) Ltd* 1990 (4) SA 608 (C); Cassim et al *Contemporary Company Law* 3 ed (2021) 687; Delport P *Henochsberg's Commentary on the Companies Act 71 of 2008* (2017) 358.
[164] S 76 of the Companies Act 2008. Subsection (1) extends the definition of a director to include (a) 'a prescribed officer or (b) a person who is a member of a committee of a board of a company, or of the audit committee of a company, irrespective of whether or not the person is also a member of the company's board' for the purpose of the standards of directors conduct.
[165] S 77 of the Companies Act 2008.
[166] The Companies Act 2008 makes provision for a number of mechanisms to hold directors of the company to account. For example, the shareholders may remove a director in terms of section

Companies Act 2008 envisages two sets of company directors. The definition recognises a director as (a) members of the board of directors as contemplated in section 66 of the Companies Act 2008 and (b) an alternate director of a company, including any person occupying the position of a director or alternate director, by whatever name designated (who are not necessarily members of the board of directors – emphasis added). For the purpose of this research, section 66(2)*(b)* of the Companies Act 2008 requires a special mention. This section states that, for a public company or a non-profit company, the minimum number of members of the company's board of directors must be three directors in addition to the number of members of the audit committee or a social and ethic committee required to be appointed in term of the Companies Act 2008 or the company's MOI. This effectively means that, where a public company or a non-profit company is required to appoint members of the company's audit committee, the board of directors of that company shall consist of the three members of the audit committee[167] *plus* three additional directors. On this basis, it is submitted that at least three members of the audit committee must be members of the company's board of directors.[168]

Despite the fact the terms 'executive' and 'non-executive' directors are well established,[169] the Companies Act 2008 does not provide for such a distinction between the types of directors.[170] In fact, it is said that the origin of the distinction is not even clear.[171] However, the *King IV Code* differentiates between executive directors, non-executive directors and independent non-executive directors.[172] An executive director is a full-time salaried employee who is involved in the day-to-day

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71(1) or may hold a director personally liable in terms of section 77 or section 218(2) or through derivative action (Section 165).

[167] S 94(2) of the Companies Act 2008 requires a public company, state-owned company or other company that is required only by its Memorandum of Incorporation to have an audit committee as contemplated in sections 34(2) and 84(l)(c)(ii), must elect an audit committee comprising *at least three members*, unless provisions of subsection (2)(a) and (b) are satisfied.

[168] It is conceivable that a public company or a non-profit company may have more than three members appointed to the company's audit committee. In such cases, it is submitted that all members of the audit committee may (but do not need to) be members of the company's board of directors.

[169] Stevens R 'The Legal Nature of the Duty of Care and Skill: Contract or Delict?' (2017) 20 *PER / PELJ* 2.

[170] Cassim et al *Contemporary Company Law* 3 ed (2021) 551.

[171] Stevens R 'The Legal Nature of the Duty of Care and Skill: Contract or Delict?' (2017) 20 *PER / PELJ* 2.

[172] Recommended Practice 7.b under Principle 7 of Part 5.3 of the *King IV Code* recommends that the composition of the company's board of directors should consider the *appropriate mix of executive, non-executive and independent non-executive directors.*

management of the company.[173] A non-executive director is a part-time director, who is not involved in the day-to-day management of the company but provides an important objective judgment independent from the full time management of the company, on issues faced by the company.[174] An independent non-executive director is neither a full-time nor part-time director of the company, and does not have any relationship with the company other than being a director.[175] This distinction of directors as executive, non-executive and independent non-executive is not without controversy, not least from the conflicting decisions of the courts. The court in *Fisheries Development Corporation of SA Ltd v Jorgensen and Another*[176] regarded the duties of non-executive directors as 'intermittent' in nature, performed at board meetings,[177] and are circumstance-based.[178] However, the court in *Howard v Herrigel & Another NNO*[179] held a different view, thus:

> …it is unhelpful and even misleading to classify company directors as 'executive' or 'non-executive' for purposes of ascertaining their duties to the company or when any specific or affirmative action is required of them. No such distinction is to be found in any statute. At common law, once a person accepts an appointment as a director, he becomes a fiduciary in relation to the company and is obliged to display the utmost good faith towards the company and in his dealings on its behalf…[180]

The court further held that:

> …it is not helpful to say of a particular director that because he was not an 'executive director' his duties were less onerous than they would have been if he was an executive director. Whether the inquiry be one in relation to negligence, reckless conduct or fraud, the legal rules are the same for all directors. In the application of those rules to the facts one must obviously take into account, for example, the factors referred to in the judgment of Margo J in the Fisheries Development case

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[173] Cassim et al *Contemporary Company Law* 3 ed (2021) 652.
[174] Cassim et al *Contemporary Company Law* 3 ed (2021) 652; Also see Mupangavanhu BM (2016) 24.
[175] Cassim et al *Contemporary Company Law* 3 ed (2021) 653-654.
[176] 1980 (4) SA 156 (T).
[177] *Fisheries Development Corporation of SA Ltd v Jorgensen and Another* 1980 (4) SA 156 (T) 165H-166B; Also see Cassim et al *Contemporary Company Law* 3 ed (2021) 653; Stevens R 'The Legal Nature of the Duty of Care and Skill: Contract or Delict?' (2017) 20 *PER / PELJ* 4.
[178] Mupangavanhu BM (2016) 112.
[179] (1991) (2) SA 660 (A).
[180] *Howard v Herrigel & Another* NNO (1991) (2) SA 660 (A) 676.

> and any others which may be relevant in judging the conduct of the director. His access to the particular information and the justification for relying upon the reports he receives from others, for example, might be relevant factors to take into account, whether or not the person is to be classified as an 'executive' or 'non-executive' director.[181]

The court in both *Fisheries Development Corporation of SA Ltd* and *Howard v Herrigel & Another NNO* recognise the fact that circumstances of each director are important when determining the director's liability. However, in the latter case, the court was not in favour of differentiating between executive and non-executive directors in so far as their duty (not liability – emphasis added) towards the company is concerned. All directors owe the same duty towards the company and are held to the same standards, and whether they are classified as executive, non-executive or independent non-executive, directors have, as a matter of law, the duty to act with independent mind in the interests of the company.[182] Presumably, this could be the reason the Companies Act 2008 is silent on the distinction between executive and non-executive directors, in keeping with the understanding that all directors are equally bound by their common law and now statutory duties.[183] The *Howard v Herrigel & Another NNO* case was cited, with approval, in the recent case of *Organisation Undoing Tax Abuse and Another v Myeni and Others,*[184] where the court held that the legal duties of all directors are the same[185] and further that the fact that someone is a 'non-executive member' does not absolve her (or him) of any legal responsibility.[186] The court in *Organisation Undoing Tax Abuse and Another v Myeni and Others* further expressed the view that 'if one considers the powers executed by non-executive directors, it is clearly appropriate that no distinction should be drawn between the two groups'.[187]

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[181] *Howard v Herrigel & Another* NNO (1991) (2) SA 660 (A) 676.
[182] *King IV Report* (2016) 28.
[183] Mupangavanhu BM (2016) 25.
[184] (15996/2017) [2020] ZAGPPHC 169 (27 May 2020).
[185] *Organisation Undoing Tax Abuse and Another v Myeni and Others* (15996/2017) [2020] ZAGPPHC 169 (27 May 2020) para 32.
[186] *Organisation Undoing Tax Abuse and Another v Myeni and Others* (15996/2017) [2020] ZAGPPHC 169 (27 May 2020) para 32.
[187] *Organisation Undoing Tax Abuse and Another v Myeni and Others* (15996/2017) [2020] ZAGPPHC 169 (27 May 2020) para 32.

For the purpose of promoting good corporate governance, directors are not obliged to give reasons why they have taken certain decisions, but they must account for their decisions.[188] In other words, directors of the company are not obliged to give reasons for every decision they make at the time of making that decision, but should be able to give reasons or account when they are required to do so. However, directors of the company, whether serving on the board of directors or not and whether they are executive, non-executive or independent non-executive directors, must adopt good corporate governance practice if they are to rely, in the course of litigation, on the protection afforded to them by the business judgment rule as provided for in the Companies Act 2008.[189] The business judgment rule is a common law principle, which is partially codified in section 76(4) of the Companies Act 2008.[190] In the absence of robust and sound governance structures and processes, it will be difficult for a director to demonstrate that reasonably diligent steps were taken to become informed;[191] that material financial interests were absent or dealt with appropriately;[192] that there was rational basis for believing – and that the director did believe – that a decision was in the best interests of the company.[193]

The above discussion has exhibited the critically important role which the directors of the company play in the domain of corporate governance. The powers and duties of directors and the relationship between directors and the company are discussed in the next segment, to further demonstrate that the entire system of corporate governance hinges on the conduct of the directors as the heartbeat of the company.

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[188] *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd & others* 2014 (5) SA 179 (WCC) para 47.
[189] *King IV Report* (2016) 35.
[190] Botha MM 'The role and duties of directors in the promotion of corporate governance: A South African perspective' (2009) 30(3) *Obiter* 710-711; Muswaka L 'Shielding Directors against Liability Imputations: The Business Judgment Rule and Good Corporate Governance' (2013) 1 *Speculum Juris* 25.
[191] *King IV Report* (2016) 35.
[192] *King IV Report* (2016) 35.
[193] *King IV Report* (2016) 35.

2.2.2.2 Powers, duties of directors and the relationship between the company and its directors

The Companies Act 2008 assigns powers to and imposes duties on the board of directors, to manage and direct the business and affairs of the company and to exercise all of the powers and perform any of the functions of the company, except to the extent that the Act or the company's MOI provides otherwise.[194] It is said that the term 'affairs' carries a much wider meaning than the term 'business',[195] with the latter referring to dealings between the company and outsiders and the former encompassing the internal relationships of the company and its very existence.[196] This includes the various internal legal relationships within the company, such as the relationship between the directors *inter se*, the relationship between the company and its directors, the relationship between the directors and shareholders, the relationship between the shareholders and the company and the shareholders *inter se*. These relationships are governed by the Companies Act 2008 and the company's MOI.[197]

As a juristic person,[198] the company has all legal powers and capacity of a natural person, except to an extent that a juristic person is incapable of exercising such powers[199] or the company's MOI limits, restricts or qualifies the purpose, powers or the activities of the company.[200] Notwithstanding the foregoing, no action of the company is void by reason that the action was inconsistent with the limitation, restriction or qualification in the company's MOI or that, as a result of such limitation, restriction or qualification, the directors had no powers to authorise the action by the company.[201] As a juristic person,[202] a company can only function through human

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[194] S 66(1) of the Companies Act 2008.
[195] *Ex Parte Russlyn Construction (Pty) Ltd* 1987 (1) SA 33 (D) 36-37; *Ex Parte New Season Auto Holdings (Pty) Ltd* 2008 (4) SA 341 (W) 345. Also see Delport P *New Entrepreneurial Law* 2 ed (2021) 114.
[196] Delport P *New Entrepreneurial Law* 2 ed (2021) 114.
[197] S 15(6) of the Companies Act 2008.
[198] S 19(1)(a) of the Companies Act 2008.
[199] S 19(1)(b)(i) of the Companies Act 2008. There are certain acts that, by their very nature, a metaphysical entity, such as company, cannot do. Some examples are, entering into a contract of marriage, obtaining a drivers' licence, or exercising the right to vote. See also Cassim et al *Contemporary Company Law* 3 ed (2021) 214-215.
[200] S 19(1)(b)(ii), read with s 20(1) of the Companies Act 2008; Also see Delport P *New Entrepreneurial Law* 2 ed (2021) 107.
[201] S 20(1)(a) of the Companies Act 2008.
[202] S 19(1)(a) of the Companies Act 2008.

functionaries.[203] It acts only through the medium of its directors and officers.[204] If certain powers are vested in the company's board of directors, through its MOI, only the board of directors alone can exercise those powers,[205] even if the board of directors, for some reason, cannot or will not exercise such powers.[206]

As already noted, directors of the company stand in fiduciary[207] relationship with the company and thus, act in a representative capacity. Although, the relationship of directors with the company is analogous to that of other fiduciaries such as agents,[208] trustees[209] or managing partners,[210] the analogy is not precise as directors of the company are in a unique relationship with the company. This unique relationship of a director to the company is considered to be *sui generis*.[211] The *locus classicus* of description of the relationship of directors to the company was convincingly stated in *Cohen v Segal*[212] thus:

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[203] Cilliers HS et al *Cilliers & Benade Company law* 3 ed (LexisNexis 2000) 5-7. See also Havenga M 'Directors' fiduciary duties under our future company-law regime' (1997) 9 *SA MercLJ* 310; *Minister of Water Affairs and Forestry v Stilfontein Gold Mining* 2006 (5) SA 333 (W) para 16.5.

[204] Cassim et al *Contemporary Company Law* 3 ed (2021) 241; Also see *Minister of Water Affairs and Forestry v Stilfontein Gold Mining* 2006 (5) SA 333 (W) para 16.5, where the court remarked that 'at any point in time, that human agencies is ultimately is the company's board of directors'.

[205] *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113 (CA) 134. Also see Pretorius JT et al *Student Case Book on Business* Entities 3 ed (Juta, 2004) 82.

[206] *Ben-Tovim v Ben-Tovim* 2001 (3) SA 1074 (C) 1086, where the court, per Erasmus AJ, held that 'whatever swings of the pendulum and differences of emphasis there might have been, it has been generally accepted that if, for some reason, the directors cannot or will not exercise powers vested in them, the general meeting (of shareholders – emphasis added) may do so'. Also see Pretorius JT et al *Student Case Book on Business* Entities 3 ed (Juta, 2004) 82. However, it is submitted that section 66(1) of the Companies Act has changed this position and therefore only directors and directors alone can exercise powers conferred to directors under the Companies Act and/or MOI. Also see Delport P *New Entrepreneurial Law* 2 ed (2021) 114.

[207] A *fiduciary* may be defined as someone who acts on behalf of and in the interest of another. See Cassim et al *Contemporary Company Law* 3 ed (2021) 553.

[208] Cassim et al *Contemporary Company Law* 3 ed (2021) 552, where is stated that, like an *'agent'*, a director acts on behalf of and for the benefit of another person, that is, the company (Also see *Ferguson v Wilson* (1866) 2 Ch App 77 89); that like a *'trustee'*, a director of the company manages the property on behalf of and for the benefit of another person, that is, the company, except that, in the case of a trustee, the property so managed is vested in the trustee and the case of a director, the property is not vested in the director but the company itself (Also see *Dadoo Ltd v Krugersdorp Municipal Council* (1920) AD 530 550-1); and that like a *'managing partner'*, a director of the company is empowered to manage the business of the company (Also see *Re Forest of Dean Coal Mining Co* (1878) LR 10 Ch 450 453), except that, unlike managing agents, a director does not necessarily have financial interest in the company.

[209] Cassim et al *Contemporary Company Law* 3 ed (2021) 553-554.

[210] Cassim et al *Contemporary Company Law* 3 ed (2021) 554-555.

[211] This means that this relationship 'stands in a class of its own'. See Cassim et al *Contemporary Company Law* 3 ed (2021) 555.

[212] 1970 (3) SA 702 (W).

> Directors are from time to time spoken of as agents, trustees or managing partners of a company, but such expressions are not used as exhaustive of the powers and responsibilities of those persons, but only as indicating useful points of view from which they may for the moment and for the particular purpose be considered, points of view at which, for the moment, they seem to be falling within the category of the suggested kind. It is not meant that they belong to the category, but that it is useful for the purpose of the moment to observe that they fall, *pro tanto*, within the principles which govern that particular class.[213]

It is evident that section 66(1) of the Companies Act 2008 confers enormous amount of powers on the directors of the company, only subject to limitation, restriction or qualification in that Act or the company's MOI. Consequently, there is a greater risk of directors, in whom wider powers are vested, to abuse these powers to the detriment of the company. Therefore, directors of the company must not exceed the powers conferred to them in term of the Companies Act 2008 or the company's MOI,[214] and must use the powers for a proper purpose[215] and within their respective powers.[216]

The board of directors may also delegate any powers conferred to it by the Companies Act 2008 or MOI to one or more board committees, except to the extent that the company's MOI states otherwise.[217] However, any such delegation of powers does not alone satisfy or constitute compliance by a director with the required duty of a director to the company as set out in section 76 of the Companies Act 2008.[218] This includes any powers or authority delegated to the company's audit committee.[219]

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[213] *Cohen v Segal* 1970 (3) SA 702 (W) at 706. Also see Cassim et al *Contemporary Company Law* 3 ed (2021) 555.
[214] Delport P *New Entrepreneurial Law* 2 ed (2021) 148.
[215] Delport P *New Entrepreneurial Law* 2 ed (2021) 148; Also see Cassim et al *Contemporary Company Law* 3 ed (2021) 708-713.
[216] *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd & others* 2014 (5) SA 179 (WCC) para 60.
[217] S 72(1)(b) of the Companies Act 2008. Also see Principle 8 of the *King IV Code.*
[218] S 72(3) of the Companies Act 2008. Also see Recommended Practice 49 under Principle 8 of Part 5.3 of the *King IV Code.* Also see Cassim et al *Contemporary Company Law* 3 ed (2021) 756, where the authors state that directors may delegate but may not abdicate their responsibilities.
[219] S 94(10) of the Companies Act 2008.

The directors' duties flow from two sources, namely the common law fiduciary duty[220] and the statutory duty in terms of the Companies Act 2008,[221] as discussed below.

2.2.2.3 Directors' common law duties

At common law, the duties to act in good faith and in the best interests of the company constitute the paramount and overarching fiduciary of directors from which all fiduciaries duties flow.[222] The fiduciary duties require of the directors of the company not to put themselves in a position where their fiduciary duties and their personal interests conflict,[223] and to exercise an independent judgment and unfettered discretion.[224] Cassim *et al* asserts that the duty to exercise an independent judgment is particularly important to nominee directors, who are appointed at the behest of the nominator to represent his or her (the nominator's) interests at the company's board meetings.[225] The common law duty also requires of the directors of the company to act within their powers[226] and to not retain any secret profit made by them in their capacity as directors while performing their directorial duties[227] or usurp any corporate opportunity that belongs to the company, which opportunity came to him or her as the director of the company.[228] In addition

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[220] The court decisions of common law jurisdictions such as England, New Zealand, USA, Canada, Australia, South Africa, etc. Cassim et al states that, in the common law jurisdictions, directors' fiduciary duties were, since the eighteenth and nineteenth centuries, judicially created and developed on case-by-case basis. See Cassim et al *Contemporary Company Law* 3 ed (2021) 683-684.

[221] S 75 and s 76 of the Companies Act 2008.

[222] Cassim et al *Contemporary Company Law* 3 ed (2021) 706.

[223] *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168 177; *Industrial Development Consultants Ltd v Cooley* [1972] 1 All ER 162 176; *Atlas Organic Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd* 1981 (2) SA 173 (T) 198; *Movie Camera Company (Pty) Ltd v Van Wyk and Another* [2003] 2 All SA 291 (C) 43.

[224] *Kregor v Hollins* (1913) 109 LT 225 (KB and CA); *Fisheries Development Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd* 1980 (4) SA 156 (W) 163. Also see Cassim et al *Contemporary Company Law* 3 ed (2021) 714.

[225] Cassim et al *Contemporary Company Law* 3 ed (2021) 715.

[226] Cassim et al *Contemporary Company Law* 3 ed (2021) 719, where it is stated that if a director has acted *ultra vires* his or her constitutional limitation or the capacity of the company, such director may incur personal liability for any loss, damages or costs suffered by the company and be called upon to compensate the company.

[227] *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 (HL); *Phillips v Fieldstone Africa (Pty) Ltd* 2004 (3) SA 465 (SCA) 479 para 31. Also see Cassim MF '*Da Silva v C H Chemicals (Pty) Ltd*: Fiduciary Duties of Resigning Directors' (2009) *SALJ* 61; Cassim et al *Contemporary Company Law* 3 ed (2021) 723-726.

[228] *Cook v Deeks* [1916] 1 AC 554 (PC) 563; Also see Havenga M 'Directors' exploitation of corporate opportunities and the Companies Act' (2013) *TSAR* 2 257 258; Cassim MF '*Da Silva v C H*

to discharging their fiduciary duties, directors are also required to exercise reasonable care, skill and diligence.

2.2.2.4 Directors' statutory duties

The common law rules of fiduciary duties such as the duty to act in good faith, honesty and loyalty,[229] have been partially codified in sections 75 and 76 of the Companies Act 2008. The duty of honesty is codified in section 75, which requires directors to declare their personal financial interests. In terms of section 76(2)*(a)* of the Companies Act 2008, a director is required to not use his or her position as a director or any information obtained in his or her capacity as a director, to benefit him or herself or another director or any person other than the company or its subsidiary[230] and must not knowingly cause harm to the company or its subsidiary.[231] Cassim *et al* asserts that, encapsulated in this section is the director's common law duty of loyalty and fidelity and the duty not to make secret personal profit out of the position as directors.[232]

A director of the company also has a statutory duty to, at the earliest practicable opportunity, communicate to the board, any information in his or her knowledge, unless there is a justifiable reason not to disclose.[233] Such reasons are that the information is immaterial to the company[234] or already generally available to the public or known to the other directors[235] or that the information is protected from disclosure by a legal or ethical duty.[236]

In terms of section 76(3) of the Companies Act 2008, a director of a company has a duty to exercise the powers and perform his or her directorial functions in good faith

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Chemicals (Pty) Ltd: Fiduciary Duties of Resigning Directors' (2009) *SALJ* 61; Cassim et al *Contemporary Company Law* 3 ed (2021) 726-736.

[229] See Cassim et al *Contemporary Company Law* 3 ed (2021) 683, where it is stated that the common law directors' duties are fiduciary duties of good faith, honesty and loyalty and that the duty of reasonable care and skill is not a fiduciary duty, as partially codified in the Companies Act.

[230] S 76(2)(a)(i) of the Companies Act 2008.

[231] S 76(2)(a)(ii) of the Companies Act 2008.

[232] Cassim et al *Contemporary Company Law* 3 ed (2021) 741. Cassim et al also submits that section 76(2)(a) is wide enough to apply to both the 'no-profit' and 'corporate opportunity' common law rules.

[233] S 76(2)(b) of the Companies Act 2008.

[234] S 76 (2)(b)(i)(aa) of the Companies Act 2008.

[235] S 76 (2)(b)(i)(bb) of the Companies Act 2008.

[236] S 76 (2)(b)(ii) of the Companies Act 2008.

and for a proper purpose,[237] and in the best interests of the company.[238] Section 76(3)*(c)* of the Companies Act 2008 necessities a special mention as, in the words of *Cassim et al*, it tightens up and upgrades the common law duty of care and skill and imposes a less subjective test and slightly more demanding standard of care on directors of the company than the common law.[239] For the purpose of convenience, section 76(3)*(c)* Companies Act 2008 shall be quoted in full, thus:

> Subject to subsections (4) and (5), a director of a company, when acting in that capacity, must exercise the powers and perform the functions of director-
>
> (a)…;
>
> (b)…; and
>
> (c) with the degree of care, skill and diligence that may reasonably be expected of a person-
>
>> (i) carrying out the same functions in relation to the company as those carried out by that director; and
>>
>> (ii) having the general knowledge, skill and experience of that director.

While the common law duty requires only care and skill, the statutory duty in section 76(3)*(c)* Companies Act 2008 has added an addition requirement of 'diligence'. This suggests that 'care' and 'diligence' are different terms with different meanings.[240] The test for standard of degree of care, skill and diligence is an objective test applicable to all directors of the company,[241] and therefore, lack of knowledge or experience or ignorance of the directors will not serve as defence.[242] However, the principle of business judgment rule, as partially codified in section 76(4) of the Companies Act 2008, may be used as mitigation or even complete defence.[243]

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[237] S 76 (3)(a) of the Companies Act 2008.
[238] S 76 (3)(b) of the Companies Act 2008.
[239] Cassim et al *Contemporary Company Law* 3 ed (2021) 751.
[240] Cassim et al *Contemporary Company Law* 3 ed (2021) 747-751.
[241] Cassim et al *Contemporary Company Law* 3 ed (2021) 752.
[242] Cassim et al *Contemporary Company Law* 3 ed (2021) 752.
[243] For a detailed discussion of the requirements of Business Judgment Rule, see Mupangavanhu BM (2016) 167-177.

The duties of directors of the company, both under common law and statutory provisions, are mandatory, prescriptive and unalterable, and apply to all companies.[244] Any provision of an agreement, the company's MOI or rules of a company, or a resolution adopted by a company, whether express or implied, is void to the extent that it directly or indirectly purports to relieve a director of his or her fiduciary duty or liability.[245] The purpose for this is that the fiduciary duties are meant to be prophylactic and preventative[246] and are protective of the company, its shareholders and the general public,[247] and therefore, a director cannot contract out of these preventative and protective measures.[248] It is submitted that this protection is also extended to the interests of other stakeholders, such as the company's creditors and employees. The protection in this context is protection from those who the Companies Act 2008 and the company's constitutive documents have enjoined with colossal powers, that is the directors acting individually or collectively as the board.

2.2.3 Shareholders as an organ of the company

2.2.3.1 Shareholders and corporate governance

As one of the two main organs of the company,[249] shareholders can and should play an important, albeit limited, role in ensuring that companies adhere to sound and effective corporate governance standards.[250] A shareholder is the holder of a share issued by a company and who is entered as such in the certificated or uncertificated securities register.[251] However, for the purpose of corporate governance, the definition of a shareholder is extended to include a person who is entitled *to exercise any voting rights* (emphasis added) in relation to a company, irrespective of the form, title or nature of the securities to which those voting rights are attached.[252] From this

[244] Cassim et al *Contemporary Company Law* 2 ed (2012) 507.
[245] S 78(2)(a) of the Companies Act 2008.
[246] Cassim et al *Contemporary Company Law* 2 ed (2012) 507.
[247] Cassim et al *Contemporary Company Law* 2 ed (2012) 507.
[248] Cassim et al *Contemporary Company Law* 2 ed (2012) 507.
[249] Cassim et al *Contemporary Company Law* 2 ed (2012) 355.
[250] Esser I & Havenga M 'Shareholder participation in corporate governance' (2008) 22(1) *Speculum Juris* 74.
[251] S 1 of the Companies Act 2008.
[252] S 57(1) of the Companies Act 2008.

definition, it is apparent that the Companies Act 2008 does not envisage a shareholder only as a person who holds shares in the company but also as any person who holds any security which entitles such person to exercise any voting right. An example of such securities is debentures. The importance of this definition is that it recognises the shareholders' significant, yet minimal, role in the life of the company. This is so, as certain substantive decisions regarding the affairs of the company are reserved for the shareholders of the company,[253] who make these decisions by voting at the shareholders' meeting.[254] It is this power to vote that is the most important tool a shareholder has to influence the behaviour of a company.[255]

Unlike directors of the company, shareholders do not have a fiduciary obligation towards the company.[256] The court in *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd & others*[257] remarked that 'despite scattered statements in case law to the effect that shareholders must vote in what they *bona fide* consider to be the best interests of the company, shareholders may generally consult their own interests. They are not subject to the fiduciary duties of directors'.[258] The same sentiments are expressed by Cassim *et al*, that the shareholder's right to vote is a proprietary right of his or her shareholding and that when a shareholder vote for or against a particular resolution, he or she votes as a person who owes no fiduciary duty to the company.[259]

Shareholders of the company could and do contribute to good corporate governance in the company through their shareholder activism.[260] This is located within a number of mechanisms as provided for in the Companies Act 2008, such as the quorum for meeting attendances and the various vote percentage required to pass shareholders' resolutions. Absence of shareholder activism undermines appropriate

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[253] Cassim et al *Contemporary Company Law* 3 ed (2021) 467.
[254] Cassim et al *Contemporary Company Law* 3 ed (2021) 467.
[255] Henderson A & van der Linde K 'Uncertificated shares: a comparative look at the voting rights of shareholders (part 1)' (2014) *TSAR* 496.
[256] Esser I & Havenga M 'Shareholder Participation in Corporate Governance' (2008) 22(1) *Speculum Juris* 78.
[257] 2014 (5) SA 179 (WCC).
[258] *Visser Sitrus (Pty) Ltd v Goede Hoop Sitrus (Pty) Ltd & others* 2014 (5) SA 179 (WCC) para 66.
[259] Cassim et al *Contemporary Company Law* 3 ed (2021) 507.
[260] Esser I & Delport P 'Shareholder protection philosophy in terms of the Companies Act 71 of 2008' 2016 (79) *THRHR* 6.

levels of managerial compliance with corporate governance.[261] As subdivision of stakeholders, it is said that shareholders are the ultimate compliance officers and can, thus, use their various rights enshrined in the company legislation, to strengthen their ability to hold board of directors to account and protect the wider stakeholder interests.[262]

2.2.3.2 Rights and powers of shareholders of the company

While section 66(1) of the Companies Act 2008 gives the company's board of directors enormous powers to manage the business and affairs of the company, this section is not inflexible. The powers of the board of directors may be altered by shareholders through the company's Memorandum of Incorporation ('MOI').[263] As the company's founding document,[264] the company's MOI sets out the rights, duties and responsibilities of shareholders, directors and others within and in relation to the company and is the sole governing document of the company.[265] The court in *Sousa and Another v Technology Corporate Management (Proprietary) Limited and Others*[266] observed that the manner in which the affairs of the company may be conducted is closely regulated by rules to which the shareholders have agreed.[267]

The shareholders of the company participate in the life of the company through the shareholders meetings. Section 1 of the Companies Act 2008 defines a 'shareholders meeting' as 'with respect to any particular matter concerning a company…a meeting of those holders of that company's issued securities who are entitled to exercise voting rights in relation to that matter'. It is through these shareholders' meetings that the Companies Act 2008 gives the shareholders some

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[261] Cassim et al *Contemporary Company Law* 3 ed (2021) 675.
[262] *King IV Report* (2016) at 32. Also see Cassim et al *The Law of Business Structures* 2 ed (2021) 341.
[263] The *alteration* of the powers of the board of directors may include negating, restricting, limiting, qualifying, extending or otherwise altering in substance or effect by that company's Memorandum of Incorporation; See S 1 of the Companies Act. Also see Cassim et al *Contemporary Company Law* 3 ed (2021) 162-166.
[264] Cassim et al *Contemporary Company Law* 3 ed (2021) 160.
[265] Cassim et al *Contemporary Company Law* 3 ed (2021) 160.
[266] (2010/50723) [2017] ZAGPJHC 109; [2017] 3 All SA 47 (GJ); 2017 (5) SA 577 (GJ) (31 March 2017).
[267] *Sousa and Another v Technology Corporate Management (Proprietary) Limited and Others* (2010/50723) [2017] ZAGPJHC 109; [2017] 3 All SA 47 (GJ); 2017 (5) SA 577 (GJ) (31 March 2017) para 36.

substantive powers, which include, but are not limited to, the power to amend the company's MOI in terms of section 16(1)*(c)*, the power to vote on and approve rules made by the board of directors relating to the governance of the company in term of section 15(4) and (5), the power to remove directors in terms of section 71(1), the power to fill vacancies on the board of directors in terms of section 70(3)*(b)* and the power to approve the disposal of all or greater part of the company's assets or undertaking in terms of section 112(2)*(a)*.[268] All these powers are exercised through a vote. However, the implication with the shareholders' right to vote is its converse right not to vote. Such shareholders' apathy is a direct threat to good corporate governance, and as *Cassim et al* summits 'it undermines good levels of compliance by management'.[269]

As stated above, section 71(1) of the Companies Act 2008 gives the shareholders of the company powers to remove directors with whom they are dissatisfied. This serves to enhance the accountability of directors of the company.[270] This is an important accountability mechanism, because directors would know that the shareholders may exercise their right to remove them from office, if they behave in an incompetent manner or engage in self-serving, opportunistic behaviour.[271] This shareholders' power strikes a balance between the directors' powers of management on the one hand and the shareholders' powers of control on the other.[272]

Unlike the directors, shareholders are not representatives of the company,[273] and therefore do not have the powers to bind the company. This, though, does not mean that shareholders can just sit and spectate as directors engage in a conduct which is inconsistent with a limitation, restriction or qualification on the company's powers, purposes or activities as specified in the company's MOI. Shareholders have the power to institute legal proceedings to restraint the company or its directors from

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[268] Also see Cassim et al *Contemporary Company Law* 3 ed (2021) 490.
[269] Cassim et al *Contemporary Company Law* 3 ed (2021) 674.
[270] Cassim R 'The power to remove company directors from office' (2019) vol. 25 no.1 *Fundamina* 55.
[271] Cassim R 'The power to remove company directors from office' (2019) vol. 25 no.1 *Fundamina* 55.
[272] Cassim R 'The power to remove company directors from office' (2019) vol. 25 no.1 *Fundamina* 55.
[273] Cassim et al *Contemporary Company Law* 3 ed (2021) 51.

contravening the relevant provisions of the company's MOI.[274] The Companies Act 2008 also empowers each shareholder of the company to institute a claim for damages against any person who intentionally, fraudulently or due to negligence causes the company to engage in anything which is inconsistent with that Act or any limitation, restriction or qualification on the company's MOI, unless such conduct has been ratified by the shareholders' meeting.[275]

The company's MOI and rules are binding on the shareholder only to an extent that the rights and obligation in the MOI and rules are conferred or imposed on the shareholder in his or her capacity as a shareholder.[276] Therefore, the company may not expect the shareholder to exercise any right, power or discharge any obligation in his or her capacity as a shareholder if such right, power or obligation is not attached to that shareholder by the company's MOI or the rules, unless otherwise exercised in terms of the Companies Act 2008 or other precedential legislation.[277]

2.2.4 The theories of corporate governance

This part of the study provides a synopsis of the different corporate governance theories which underpin the role and the effectiveness of the audit committee within corporate governance. The aim is to highlight the important connection between the role of the board of directors and shareholders on the one hand and the role of the audit committee on the other hand in pursuit of good corporate governance outcomes. There are many corporate governance theories, which evolve with the forever evolving corporate world. However, only three key corporate governance theories, which are relevant to this study, are discussed below, namely the agency theory, the stakeholder theory and the institutional theory.

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[274] S 20(5). Also see Cassim et al *The Law of Business Structures* 2 ed (2021) 156.
[275] S 20(6) of the Companies Act 2008.
[276] S 15(6)(a) of the Companies Act 2008. Also see Cassim et al *The Law of Business Structures* 2 ed (2021) 136.
[277] S 5(4)(b) of the Companies Act 2008 provides for a list of legislations whose provisions take precedence in circumstance where the provisions of the Companies Act 2008 and the provisions these legislations are inconsistent with each other and it is impossible to reconcile such inconsistencies.

2.2.4.1 The agency theory

The agency theory is also referred to as the contractarian theory.[278] This theory views the company as a voluntary and private contractual relationship by individuals who exercise their freedom to contract with each other freely.[279] Fundamentally, the agency theory recognises the relationship between the company's board of directors and the shareholders. It does this by positing the assumption that the directors of the company act as agents on behalf and for the benefit of company's shareholders, as the principal.[280] However, this theory also reaffirms the long standing corporate law principle that a company is a separate legal entity from the date and time of incorporation[281] and that shareholders are not the owners of the company.[282]

It is said that, in an agent-principal relationship where an agent acts on behalf and in the interest of another person, there are bound to be conflicts,[283] with the assumption that the directors of the company can be tempted to exploit the company for their own benefit.[284] This assumption raises the fear that directors of the company may not necessarily act in the interests of the shareholders or the company but may, instead, act in a manner that advances their own interests to the detriment of shareholders or the company.[285] This brings into focus the role of the audit committee. The audit committee is an integral part of corporate governance[286] and can play an important role to allay the agency theory fear highlighted above. The board of directors is responsible for the production of financial statements and reporting. The audit committee is expected to provide an independent assurance on the integrity of the financial statements and reporting process to the shareholders. When the independence and the effectiveness of the audit committee are in doubt,

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[278] Mupangavanhu BM (2016) 37.
[279] Mupangavanhu BM (2016) 37.
[280] Borlea SN & Achim M 'Theories of corporate governance' (2013) 23 (1) *Vasile Goldis Western University Economics Series* 118.
[281] See *Salomon v Salomon & co Ltd.* [1897] AC 22 (HL) para 51; Also see s 19(1) of the Companies Act 2008.
[282] Mupangavanhu BM (2016) 39.
[283] Younas A 'Review of Corporate Governance Theories' (2022) 7 (6) *European Journal of Business and Management Research* 80.
[284] Masli MA *The Role of the Audit Committee as a Corporate Governance Mechanism: The Case of the Banking Sector in Libya* (published PhD thesis, Nottingham Trent University 2018) 28.
[285] Mupangavanhu BM (2016) 39.
[286] Akwenye NJ, Chata T & Benedict OH 'Establishment of audit committee in government ministries of a developing country' (2016) 6(4) *Risk Governance & Control: Financial Markets & Institutions* 284.

the shareholders may fear that the board of directors or individual directors may engage in a conduct which is to their own benefit and which may be detriment to the company and its various stakeholders.

2.2.4.2 The stakeholder theory

While the agency theory discussed above focuses on the interests of the shareholders only, the stakeholder theory stresses the importance of creating values of all stakeholders of the company.[287] In this sense, stakeholders refer to all persons, groups or organisations that have an impact on or are impacted by the activities of the company, such as shareholders, investors, employees, customers, suppliers, business partners, competitors, the government, pressure groups, communities and even the media.[288] From this premise, the directors, as the stewards and driving mind in the life of the company, must conduct the business and affairs of the company in a manner that takes into consideration the interests of all individuals who have an interest in the company's activities and who can impact or be impacted by the company's failure or success.[289] This underscores the responsibility of the directors towards a wider group of constituents and not just shareholders of the company.[290] In this regard, the audit committee's oversight role in ensuring that the company provides accurate, reliable and credible financial and non-financial information to the community of the company's stakeholders is vital. The audit committee must discharge this responsibility with the necessary independence and acceptable level of effectiveness.

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[287] Younas A 'Review of Corporate Governance Theories' (2022) 7 (6) *European Journal of Business and Management Research* 81.

[288] Borlea SN & Achim M 'Theories of corporate governance' (2013) 23 (1) *Vasile Goldis Western University Economics Series* 121.

[289] Masli MA *The Role of the Audit Committee as a Corporate Governance Mechanism: The Case of the Banking Sector in Libya* (published PhD thesis, Nottingham Trent University 2018) 30.

[290] Masli MA *The Role of the Audit Committee as a Corporate Governance Mechanism: The Case of the Banking Sector in Libya* (published PhD thesis, Nottingham Trent University 2018) 31.

2.2.4.3 The institutional theory

The institutional theory is based on the conviction that a company is not just a place where goods and services are traded but also that companies operate within social and cultural systems.[291] This theory claims that organisations cannot survive without legitimacy.[292] This means that there must be an approval by the societies within which organisations operates, that the organisations' actions are desirable and suitable.[293] As companies operate within social and cultural settings, this theory claims that many corporate governance mechanisms such as the audit committee are established merely to conform to social expectations.[294] The reason for this is that the institutional theory views many governance instruments as the products of coercion by legislators seeking to improve organisational effectiveness through the imposition of specific practices.[295] However, it is said that the institutional theory offers a useful perspective for investigating the role of the audit committee as the this theory is said to be concerned with creating legitimacy.[296] In this respect, the inquiry into the independence of the audit committee and the protection of that independence should also be viewed with the lens of the legitimacy of the company's actions. As a corporate governance and financial reporting watch dog for stakeholders in general and shareholders in particular,[297] an independent and effective audit committee may allay any fear that the company may be engaged in an illegitimate conduct.

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[291] Al Mamun A, Yasser QR & Rahman A 'A Discussion of the Suitability of Only One vs More than One Theory for Depicting Corporate Governance' (2013) 4 *Modern Economy* 44.
[292] Al Mamun A, Yasser QR & Rahman A 'A Discussion of the Suitability of Only One vs More than One Theory for Depicting Corporate Governance' (2013) 4 *Modern Economy* 44.
[293] Al Mamun A, Yasser QR & Rahman A 'A Discussion of the Suitability of Only One vs More than One Theory for Depicting Corporate Governance' (2013) 4 *Modern Economy* 44.
[294] Masli MA *The Role of the Audit Committee as a Corporate Governance Mechanism: The Case of the Banking Sector in Libya* (published PhD thesis, Nottingham Trent University 2018) 33.
[295] Masli MA *The Role of the Audit Committee as a Corporate Governance Mechanism: The Case of the Banking Sector in Libya* (published PhD thesis, Nottingham Trent University 2018) 33.
[296] Masli MA *The Role of the Audit Committee as a Corporate Governance Mechanism: The Case of the Banking Sector in Libya* (published PhD thesis, Nottingham Trent University 2018) 33-34.
[297] Chukwunedu OS & Okafor OG 'Repositioning the Audit Committee as an Effective Watchdog in Corporate Governance in Nigeria'(2010) vol 10 *Journal of the Management Sciences* 5; Marx B (2008) 21.

2.2.5 Corporate governance under Public Finance Management Act

This segment of the study discusses the corporate governance role of the accounting and executive authorities in public entities under the PFMA. The purpose is to demonstrate the significance of these authorities in compliance with good and sound corporate governance.[298] Good corporate governance is paramount to the success of the public entities, to protect and advance the interests of the country and its citizenry.[299] It also helps to enhance the effective functioning of leadership structures within the public entities.[300] The relevance of this segment to the overall objective of this study is to set the tone for a discussion in chapters to follow, of the role of accounting and executive authorities in relation to the protection or lack of, of the audit committees of public entities.

2.2.5.1 Accounting authority

The Companies Act 2008 and the PFMA do not provide a clear definition of the phrase 'accounting authority'. However, the Companies Act 2008 defines a state-owned company as an enterprise that is registered as a company in terms of that Act, and is either listed as a public entity in Schedule 2 or 3 of the PFMA or owned by a municipality.[301] The PFMA defines a public entity as a national or provincial public entity.[302] From these definitions, it is clear that a public entity is a company owned by the State under the National, Provincial or Local government. As a company, a public entity is subject to the provisions of the Companies Act 2008 and as a public entity, it is also subject to the provisions of the PFMA.

For a public entity (also referred to as 'SOEs') which has board of directors or a controlling body, such board of directors or a controlling body is the accounting

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[298] See *King IV Report* (2016) 12, where the Report defines the 'governing body' as a structure that has the primary responsibility for the governance and performance of the organisation, and includes board of directors and accounting authorities of state-owned entities, among others. For the purpose of public entities (referred to as SOEs in the *King IV Report* (2016) 122) governing body means an accounting authority as defined in the PFMA or the board or other terminology as provided for in the enabling legislation.

[299] *King IV Report* (2016) 111.

[300] *King IV Report* (2016) 111.

[301] S 1 of the Companies Act 2008.

[302] S 1 of the Public Finance Management Act 1 of 1999.

authority of that public entity.[303] This means that if the public entity has a board of directors, such board is governed by the Companies Act 2008, the company's MOI and any company rules. As an accounting authority, the board is also governed by the PFMA. The board of the public entity must uphold good and sound corporate governance in the public entity consistent with fiduciary duties as contemplated in section 50 and other responsibilities in terms of section 51 the PFMA and its regulations. The court in *Airports Company South Africa SOC Ltd v Imperial Group Ltd & Others*[304] held that the object of section 2 of the PFMA is to 'secure transparency, accountability, and sound management of the revenue, expenditure, assets and liabilities of the institutions to which this Act applies and that obligations consistent with these objects are therefore placed on the accounting authority of [the public entity]'.[305] The accounting authority of the SOE is responsible for the strategic direction and leadership of the entity and for ensuring that corporate governance and ethics are observed.[306] It should serve as the focal point and custodian of corporate governance in the SOEs,[307] and is accountable to the entity's executive authority.[308]

Where the public entity does not have the board of directors and a controlling body, the entity's CEO or any other person in charge of that public entity is the accounting authority of that public entity, unless specific legislation applicable to that public entity designates another person as the accounting authority.[309] In this respect, the court in *Cash Paymaster Services (Pty) Ltd v Chief Executive Officer of the SASSA and others*[310] reaffirmed the object of the PFMA and remarked that the obligations consistent with that object are placed on the CEO of the public entity, as its accounting authority.[311] It is submitted that, in the absence of board of directors or

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[303] S 49(2)(a) of the Public Finance Management Act 1 of 1999.
[304] (1306/18) [2020] ZASCA 02 (31 January 2020).
[305] *Airports Company South Africa SOC Ltd v Imperial Group Ltd & Others* (1306/18) [2020] ZASCA 02 (31 January 2020) para 23.
[306] Thabane T & Snyman-Van Deventer E 'Pathological Corporate Governance Deficiencies in South Africa's State-Owned Companies: A Critical Reflection' (2018) 21 *PER /PELJ* 12.
[307] Principle 6 under Part 6.6 of the *King IV Code.*
[308] *Organisation Undoing Tax Abuse and Another v Myeni and Others* (15996/2017) [2020] ZAGPPHC 169 (27 May 2020) para 27.
[309] S 49(2)(b) of the Public Finance Management Act 1 of 1999.
[310] (1029/2018) [2019] ZASCA 131 (30 September 2019).
[311] *Cash Paymaster Services (Pty) Ltd v Chief Executive Officer of the SASSA and others* (1029/2018) [2019] ZASCA 131 (30 September 2019) para 36.

a controlling body, the CEO is the ultimate executive director responsible not only for the management of the business and affairs of the public entity but also for compliance with the legislative framework and regulatory code governing the public entity.

The PFMA makes provision for the relevant treasury to, in exceptional circumstances, approve or instruct that another functionary of the public entity must be the accounting authority for the public entity.[312] It must be noted that if and when the relevant treasury approves or instructs that another functionary of the public entity become the accounting authority for that public entity, such functionary will not only be an accounting authority for the purpose of the PFMA but also be regarded a director of that entity as defined in section 1 of the Companies Act 2008. As a director, such functionary of the public entity is to be the focal point of the entity's corporate governance.

2.2.5.2 Executive authority

For purposes of the *King IV Code*, an executive authority is defined as a shareholder as contemplated in the Companies Act 2008.[313] Section 1 of the PFMA defines an executive authority of a public entity as a Cabinet member accountable to Parliament or a member of a provincial Executive Council accountable to Provincial Legislature for that public entity or the portfolio under which the public entity falls. Like a shareholder under the Companies Act 2008, an executive authority, as a shareholder in the public entity, is not involved in the management of the business and affairs of the public entity.

As a shareholder of the public entity, an executive authority enjoys all the powers, rights and obligations under the Companies Act 2008 as discussed above and the relevant provisions of the PFMA. Under the PFMA, an executive authority has

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[312] S 49(3) of the Public Finance Management Act 1 of 1999.

[313] *King IV Report* (2016) 112. Section 1 of the Companies Act 2008 defines 'a shareholder' as the holder of a share issued by a company and who is entered as such in the certificated or uncertificated securities register, as the case may be. For the purpose of corporate governance, section 51(1) of the Companies Act 2008 extends the meaning of 'a shareholder' to also include a person who is entitled to exercise any voting rights in relation to a company, irrespective of the form, title or nature of the securities to which those voting rights are attached.

powers to approve certain significant transactions of the public entity.[314] In *Passenger Rail Agency of South Africa v Swifambo Rail Agency (Pty) Ltd,*[315] the court set aside a contract after it found, *inter alia*, that the prerequisite approval by the executive authority of a public entity, the applicant in that case, which was necessary in terms of section 54(2) of the PFMA, was not obtained.[316] However, while the Constitutional Court in *Road Traffic Management Corporation v Waymark (Pty) Limited*[317] accepted that section 54(2) of the PFMA obliges the accounting authority to seek approval from the relevant executive authority for significant transactions, including the acquisition or disposal of a significant asset, the court observed that '…for the most part it is the accounting authority that is in charge of a public entity's general expenditure and finances'.[318] In this regard, the court reaffirmed the long standing corporate governance philosophy, that it is the board of directors of the company or the accounting authority under the PFMA, which is enjoined with the power to manage the business and affairs of the company, and not the shareholders, or an executive authority under the PFMA.[319]

Section 63(2) of the PFMA endows the executive authority of the public entity to exercise executive's ownership control powers to ensure that such public entity complies with that Act and the financial policies of that executive. Section 1 of the PFMA defines 'ownership control' as the ability to exercise some powers to govern the financial and operating policies of the entity, which powers includes, *inter alia*, to 'appoint or remove all, or the majority of, the members of that entity's board of directors or equivalent governing body (such as the accounting authority – emphasis added)' and to 'appoint or remove that entity's CEO (who will serve as the entity's accounting authority if the entity does not have a board of directors or a controlling body – emphasis added)'. From this definition, it is apparent that the PFMA gives

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[314] S 54(2) of the Public Finance Management Act 1 of 1999; Also see *Road Traffic Management Corporation v Waymark (Pty) Limited* [2018] ZACC 12 para 42.

[315] (2015/42219) [2017] ZAGPJHC 177; [2017] 3 All SA 971 (GJ); 2017 (6) SA 223 (GJ) (3 July 2017).

[316] *Passenger Rail Agency of South Africa v Swifambo Rail Agency (Pty) Ltd* (2015/42219) [2017] ZAGPJHC 177; [2017] 3 All SA 971 (GJ); 2017 (6) SA 223 (GJ) (3 July 2017) para 70.

[317] [2018] ZACC 12.

[318] *Road Traffic Management Corporation v Waymark (Pty) Limited* [2018] ZACC 12 para 42.

[319] S 66 of the Companies Act 2008 empowers the board of directors to manage the business and affairs of the company and section 49(2) equates the accounting authority of a public entity to the board of directors or a similar controlling body. Therefore, both the Companies Act 2008 and the PFMA respectively exclude shareholders and executive authorities from the management of the business and affairs of privately-owned company and public entities.

the executive authority of the public entity enormous powers to decide who serves as or as part of the entity's accounting authority. The powers of the executive authority of the public entity under the PFMA also include the power to cast all, or the majority of, the votes at meetings of the board of directors or equivalent governing body and to control all, or the majority of, the voting rights at a general meeting of that entity.[320] In terms of the Treasury Regulations for PFMA, the executive authority must concur with any premature termination of services of a member of the audit committee.[321]

2.2.6 The King IV Code on corporate governance

King IV Code is a voluntary[322] code contained in the *King IV Report*. The *King IV Report* is the product of the work of the King Committee on Corporate Governance, which is a committee established by the Institute of Directors in South Africa (IoDSA).[323] As it is a voluntary code, compliance with *King IV Code* is generally not a mandatory requirement, except for corporations which are listed on the Johannesburg Stock Exchange ('JSE')[324] and public entities.[325] However, the *King IV Report* aspires to apply to all companies, regardless of their size and form of incorporation.[326]It uses the principle of 'apply and explain',[327] which requires companies to not only apply the recommended corporate governance principles embedded in the *King IV Code* but to also demonstrate how good governance is being practised.[328] This requires companies to be transparent in their application of corporate governance practices.[329]

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[320] S 63(2), read with S1 the Public Finance Management Act 1 of 1999.
[321] Regulation 27.1.5 of the Treasury Regulation for PFMA.
[322] *King IV Report* (2016) 35, where the Report sets its legal status as 'that of a set of voluntary principles and leading practices'.
[323] See IoDSA 'History of the King Committee' available at https://www.iodsa.co.za/page/king-iv (accessed on 06 May 2021).
[324] See section 8.63(a) of the Johannesburg Stock Exchange Listing Requirements available at https://www.jse.co.za/content/JSERulesPoliciesandRegulationItems/JSE%20Listings%20Requirements.pdf (accessed on 5 May 2020).
[325] See *South African Broadcasting Corporation v Mpofu* para 29, where the court remarked that the conduct of public enterprises must be measured against the relevant principles of the code and must adhere to best practices.
[326] *King IV Report* (2016) 35.
[327] See the Foreword to the *King IV Report* (2016) at 7; Also see the *King IV Report* (2016) at 37 for more details on the 'Apply principles' and the 'Explain practices'.
[328] See *King IV Report* (2016) 7.
[329] See PwC 'A summary of the King IV Report on Corporate Governance for South Africa, 2016'

The *King IV Report* defines corporate governance as 'the exercise of ethical and effective leadership by the governing body towards the achievement of the following governance outcomes: ethical culture, good performance, effective control and legitimacy'.[330] It differentiates corporate governance from other forms of governance and highlights that corporate governance applies to legal entities such as companies, voluntary associations, trusts, retirement fund and other legislated entities which exist separately from their incorporators or founders.[331] To realise corporate governance ethos of ethical culture, good performance, effective control and legitimacy, Principle 6 under Part 5.3 of the *King IV Code* recommends that the corporations' governing bodies (and boards of directors of companies) should serve as the focal point and custodian of corporate governance in those corporations.[332] Audit committees have embedded themselves in entities' corporate governance structures[333] as an important corporate governance mechanism.[334] The connection between the audit committee and corporate governance is discussed below.[335] For purposes of this exposition, it is important to highlight that the *King IV Code* recognises that the establishment of an audit committee is a statutory requirement for some companies.[336] In this respect, the *King IV Code* recommends that companies which issue audited financial statements should appoint audit committees whose role should be to provide an independent oversight of the assurance functions and the integrity of the annual financial statements.[337]

2.2.7 Audit committee and corporate governance

As already stated, audit committees have embedded themselves in entities' corporate governance structures over the years .[338] They are seen as an important

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available on https://www.pwc.co.za/en/publications/king4.html (accessed on 06 May 2021).

[330] See *King IV Report* (2016) 20.
[331] See *King IV Report* (2016) 11.
[332] See *King IV Report* (2016) 49.
[333] Marx B (2008) 19.
[334] van der Nest et al 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 549. Also see Cassim et al *The Law of Business Structures* 2 ed (2021) 332, where it is stated that 'an independent audit committee plays a central role in corporate governance'.
[335] See the discussion in point 2.6 below.
[336] Recommended Practice 51 under Principle 8 of Part 5.3 of the *King IV Code.*
[337] Recommended Practice 51 under Principle 8 of Part 5.3 of the *King IV Code.*
[338] Marx B (2008) 19.

mechanism in corporate governance[339] and the oversight watchdog of financial reporting process and the system of internal control and risk management.[340] The establishment of the audit committee is aimed at mitigating corporate fraudulent or creative accounting practices, through internal controls initiated by independent and effectively functioning non-executive members of the audit committee.[341] As an integral part of corporate governance,[342] the modern audit committee of the company acts as the 'guard dog' and 'watch dog' for stakeholders in general and shareholders in particular regarding the entity's financial reporting, risk management, control and audit functions.[343]

The Organisation for Economic Co-operation and Development[344] ('the OECD') recommends that the audit committee should provide oversight of the internal audit activities and should also be charged with overseeing the overall relationship with the external auditor, including the nature of non-audit services provided by the auditor to the company.[345] This OECD principle is echoed by the *King IV Report*, which recommends that governing bodies (that is, boards of directors or accounting authorities) of any company which issues audited financial statements should consider establishment of an audit committee, whose role should be to provide independent oversight of the effectiveness of the company's assurance functions and service, with particular focus on combined assurance arrangements, including external assurance service providers, internal audit and the finance function.[346] In

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[339] van der Nest et al 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 549. Also see Cassim et al *The Law of Business Structures* 2 ed (2021) 332, where it is stated that 'an independent audit committee plays a central role in corporate governance'.

[340] Marx B (2008) 279.

[341] Al-Mahamid SM & Al–Sa'eed 'Features of an effective audit committee, and its role in strengthening the financial reporting: Evidence from Amman Stock Exchange' (2011) vol. 1, no. 1 *Journal of Public Administration and Governance* 40.

[342] Akwenye NJ, Chata T & Benedict OH 'Establishment of audit committee in government ministries of a developing country' (2016) 6(4) *Risk Governance & Control: Financial Markets & Institutions* 284.

[343] Marx B (2008) 21.

[344] OECD (2015) G20/OECD Principles of Corporate Governance, OECD Publishing, Paris at 43, available at https://www.oecd-ilibrary.org/docserver/9789264236882-en.pdf?expires=1590778575&id=id&accname=guest&checksum=C280B15938B40DD6E757E6E483B204EF (accessed on 29 May 2020).

[345] OECD (2015) G20/OECD Principles of Corporate Governance, OECD Publishing, Paris at 43,

[346] Recommended Practice 51 under Principle 8 of Part 5.3 of the *King IV Code.*

terms of the Companies Act 2008, the audit committee may perform such other oversight functions as may be determined by the board of directors.[347]

The responsibilities of the audit committee include the requirement to contribute to an improvement in the corporate governance of the organisation.[348] Through its oversight function, the audit committee assists governing bodies in meeting their financial reporting, risk management and control, audit-related responsibilities and in dealing with emerging issues such as fostering an ethical culture of doing business and as well as overseeing the company's integrated sustainability reporting.[349] In public entities, the audit committee is an integral element of public accountability and governance.[350] It has the duty to resolve any differences in opinion between the external auditor and management.[351] In the spirit of stakeholder-inclusivity,[352] the role of the audit committee also includes exercising oversight responsibility on behalf of the organization's governing bodies to ensure that the organisation provides accurate, reliable and credible financial and non-financial information to various stakeholder groupings.[353]

To promote fearless expression of independent judgment on corporate governance issues, the audit committee should meet, on an annual basis, with both internal and external audit teams, in the absence of the company's management, to facilitate exchange of views and concerns that may not be appropriate for discussion in the presence of the management.[354] It is submitted that this recommended practice could inspire both members of the audit committee and audit teams to courageously provide an open and frank input into the status of the company's corporate

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[347] S 94(7)(i) of the Companies Act 2008.

[348] van der Nest et al 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 555.

[349] Marx B & van der Watt A 'Sustainability and integrated Reporting: An analysis of the audit committee's oversight role' vol 9 (2) *Journal for New Generation Sciences* 58.

[350] van der Nest et al 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 551.

[351] van der Nest et al 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 555.

[352] See *King IV Report* (2016) 17, where shareholder-inclusivity is defined as 'an approach in which the governing takes into account the legitimate and reasonable needs, interests and expectations of all material stakeholders in the execution of its duties in the best interest of the organisation over time'.

[353] Marx B & van der Watt A 'Sustainability and integrated Reporting: An analysis of the audit committee's oversight role' vol 9 (2) *Journal for New Generation Sciences* 61.

[354] Recommended Practice 58 under Principle 8 of Part 5.3 of the *King IV Code.*

governance and highlight areas of concern. For public entities, the audit committee has the duty to review the public entity's compliance with legal and regulatory provisions[355] and may communicate any concerns to the executive authority of the public entity, the Auditor-General and external auditor.[356]

2.3 THE RELATIONSHIP BETWEEN THE AUDIT COMMITTEE, THE COMPANY AND ITS KEY STAKEHOLDERS

2.3.1 The audit committee and the company: A subcommittee of the board or an organ of the company?

It was briefly highlighted in Chapter 1 above,[357] that there are contradictory views as to whether or not the audit committee is a committee of the company's board of directors. Some authors submit that the audit committee is not a committee of the board of directors but an independent committee of the company.[358] Delport is of the view that, while the organs of the company are ordinarily the board of directors and shareholders, the Companies Act 2008 has introduced two additional organs of the company, namely the social and ethics committee and the audit committee.[359] It is propounded in this segment of the study that Delport's view is convincing and appears to be the correct purposive interpretation of the legislative intention of the Companies Act 2008.[360]

Other leading authors on the topic of the audit committee express a contrasting observation, as it is demonstrated below. After evaluating various definitions and descriptions of the concept of audit committee from various other authors, Marx concludes that 'the audit committee should function as a subcommittee of the board

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[355] Regulation 27.1.8(f) of the Treasury Regulation for PFMA.
[356] Regulation 27.1.12 of the Treasury Regulation for PFMA.
[357] See the discussion in point 1.1.3.2 in Chapter 1 of this thesis.
[358] Delport P *Henochsberg's Commentary on the Companies Act 71 of 2008* (2017) 356. Also see Hendrikse JW & Hefer L *Corporate Governance Handbook: Principle and Practice* 3 ed (2019) 389, where it is stated that 'previously, the audit committee was a subcommittee of the board of directors'. Also see Wixley T, Everingham G & Louw K *Corporate Governance: The Directors' Guide* 5 ed (2019) 110.
[359] Delport P *New Entrepreneurial Law* 2 ed (2021) 113.
[360] See section 7(b)(iii) of the Companies Act 2008, where it sets out the purpose of the Companies Act 2008 as, among others, to encourage transparency and high standards of corporate governance in light of the significant role companies play within the social and economic life of the nation.

of directors, of which the majority of members should be independent non-executive directors'.[361] This expression is supported by Ferreira[362] and Ncube,[363] among many other local and foreign authors.[364] The OECD refers to the audit committee as an independent audit committee of the board.[365] Cassim *et al* describes audit committee as 'a sub-committee of the company's board of directors, appointed by that company's incorporators, board of directors or shareholders, which plays an important role in identifying financial risks, managing these risks, ensuring the integrity of internal financial controls and ensuring the integrity of integrated reporting'.[366] Surprisingly, the *King IV Report* neither defines the concept of audit committee nor provides any guidelines as to whether an audit committee should be a committee of the board of directors or an independent standalone committee of the company.

The Companies Act 2008 makes provision for the establishment of board committees by the board of directors[367] and delegation of any authority of the board to such board committees.[368] Despite the creation of board committees and delegation of any powers or any acts performed by these committees, the directors, individually or collectively as a board, are not relieved of their duties as set out in section 76 of the Companies Act 2008.[369] It must also be noted that, as the business and affairs of the company are managed by or under the direction of the board of directors,[370] it is the board that assumes the ultimate responsibility for exercise of

[361] Marx B (2008) 42.
[362] Ferreira I 'The effect of audit committee composition and structure on the performance of audit committees' (2008) vol. 16 no. 2 *Meditari Accountancy Research* 93.
[363] Ncube CB 'Transparency and accountability under the new company law' (2010) *Acta Juridica* 67.
[364] Also see Magrane J & Malthus S 'Audit Committee Effectiveness: A Public Sector Case Study' (2010) vol. 25 Iss: 5 *Managerial Auditing Journal* 427-443; Akwenye NJ, Chata T & Benedict OH 'Establishment of audit committee in government ministries of a developing country' (2016) 6(4) *Risk Governance & Control: Financial Markets & Institutions* 285; Zábojníková G *The Audit Committee Characteristics and Firm Performance: Evidence from the UK* (Masters in Finance dissertation, Porto University, 2016) 1.
[365] OECD (2015) G20/OECD Principles of Corporate Governance, OECD Publishing, Paris, available at https://www.oecd-ilibrary.org/docserver/9789264236882-en.pdf?expires=1590778575&id=id&accname=guest&checksum=C280B15938B40DD6E757E6E483B204EF (accessed on 29 May 2020).
[366] Cassim et al *The Law of Business Structures* 2 ed (2021) 1xxi.
[367] S 72(1)(a) of the Companies Act 2008.
[368] S 72(1)(b) of the Companies Act 2008.
[369] S 72(3) of the Companies Act 2008.
[370] As set out in section 66(1) of the Companies Act 2008.

delegated powers[371] and remains liable for the proper performance of the duty so delegated.[372] Put differently, while the board of directors may delegate its powers to a board committee, it cannot abdicate its legal responsibility for the conduct of the board committee.[373]

An important question to ask is: what could have been the legislative intention of the provisions of section 94 of the Companies Act 2008, if the audit committee is to be regarded as a committee of the board of directors? If it is to be settled that the position under the Companies Act 2008 is that the audit committee is a committee of the company's board of directors, then the provisions of section 94 become redundant for a number of reasons. Such redundancy may be located within the following factors: that (i) the audit committee would be established in terms of the provisions of section 72 of the Companies Act 2008 as a subcommittee of the board of directors, (ii) like directors appointed to other board subcommittees,[374] the directors appointed on the audit committee would not need to be independent directors, and (iii) the audit committee would derive its mandate from the board resolution establishing it. It therefore follows that the provisions of section 94 of the Companies Act 2008 were implanted for a specific jurisprudential purpose, which purpose could not be achieved by the provisions of section 72.

The provisions of section 94 of the Companies Act 2008 appear to contemplate the establishment and maintenance of an independent committee.[375] What is not settled yet, it is submitted, is whether or not such committee is a committee of the company's board of directors. It is submitted that the audit committee as contemplated in section 94 of the Companies Act 2008 cannot possibly be a committee of the company's board of directors.[376] The fact that the audit committee

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[371] Recommended Practice 52 under Principle 8 of Part 5.3 of the *King IV Code.*
[372] Cassim et al *Contemporary Company Law* 3 ed (2021) 623.
[373] Cassim et al *Contemporary Company Law* 3 ed (2021) 623.
[374] For example: Finance Committee, Human Resources Committee, Investment Committee, Remuneration Committee or other subcommittees which may be established by the Board's resolution.
[375] S 94(2) of the Companies Act 2008 requires members of the audit committee to be elected by the company's shareholders. S 94(4)(b) of the Companies Act 2008 precludes executive directors, employees, suppliers and customers of the company from serving as members of that company's audit committee. S 94(4)(c) of the Companies Act 2008 precludes any person related to executive directors, employees, suppliers and customers of the company from serving as members of that company's audit committee.
[376] See Delport P *New Entrepreneurial Law* 2 ed (2021) 146, where it is stated that 'the audit

is appointed by the company's shareholders[377] makes such committee derive original powers from the Companies Act 2008 and the company's MOI.[378] It becomes a standalone organ of the company, and like other organs of the company, its powers and functions are determined by the Companies Act 2008 and the MOI.[379] The division of powers among organs of the company is absolute and original.[380] This means that one organ of the company cannot arrogate the powers and functions of the other.[381] Consequently, the board of directors cannot usurp powers and functions of the audit committee. Unlike the board committees contemplated in section 72 of the Companies Act 2008, which derive their duties and powers from and are accountable to the board, the audit committee derives its authority and duties directly from the legislation.[382]

The members of the company's audit committee are appointed at the annual general meeting.[383] The Companies Act 2008 defines 'annual general meeting' as a meeting of shareholders of the public company as contemplated in section 61(7) of the Act.[384] It therefore must be noted that the annual general meeting of the company is not a meeting of the company's board of directors.[385] A private company, personal liability company, or non-profit company is generally not required to appoint an audit committee, unless such company is required to do so in terms of the provisions of its MOI or required by the Companies Act 2008 or Company Regulations 2011 to have its financial statements audited annually.[386] If a private company, personal liability company, or non-profit company is required to appoint an audit committee, such committee must be appointed at the annual general meeting of

committee is also a separate organ of the company and is not a board committee within the meaning attributed to it in section 72'.

[377] Although section 94(2) of the Companies Act 2008 does not specifically use the term 'appoint', it is submitted that the effect of the election of members to serve on the audit committee is in fact an appointment to that committee.

[378] Delport P *New Entrepreneurial Law* 2 ed (2021) 113.

[379] Delport P *New Entrepreneurial Law* 2 ed (2021) 113.

[380] Delport P *New Entrepreneurial Law* 2 ed (2021) 113.

[381] Delport P *New Entrepreneurial Law* 2 ed (2021) 113.

[382] Hendrikse JW & Hefer L *Corporate Governance Handbook: Principle and Practice* 3 ed (2019) 391. The audit committee under the Companies Act 2008 derives its powers and duties from section 94(7) of that Act.

[383] S 61(8)(c)(ii) of the Companies Act 2008.

[384] S 1, read with section 61(7) of the Companies Act 2008.

[385] Delport P *Henochsberg's Commentary on the Companies Act 71 of 2008* (2017) 357.

[386] S 34(2), read with section 84(1)(c)(ii) of the Companies Act 2008.

shareholders.[387] It therefore follows that the audit committee is accountable to the shareholders by whom it is appointed.[388]

The audit committee is a creation of the statute.[389] Thus, it is submitted that the legislative intention of the provisions of section 94 of the Companies Act 2008 is not to establish an independent committee of the company's board of directors but rather a standalone committee, independent of the board of directors and management. This interpretation amplifies the purpose of the Companies Act as set out in section 7, thus, 'encouraging transparency and high standards of corporate governance as appropriate…'[390] given the significance of the role the audit committee *vis-a-vis* the enormous powers of the board of directors set out in section 66(1) of the Companies Act 2008. The committees of the company's board of directors are established in terms of provisions of section 72 of the Companies Act 2008. As committees of the board of directors, it is submitted that the section 72 committees are not independent and need not be. The independence contemplated by the provisions of section 94 of the Companies Act 2008 is not independence of the audit committee from the outside world; nor is it independence from shareholders, employees or other stakeholders, like suppliers and debtors. It is an independence from the company's board of directors and the management as a delegated structure. On this basis, it is submitted that an audit committee cannot imaginably be a subcommittee of the body or a structure from which it must be independent and protected. Further, section 88(2)*(d)* of the Companies Act 2008 sets out the duties of the Company Secretary, to include ensuring that minutes of all shareholders meetings, board meetings and the meetings of any committees of the directors, or of the *company's audit committee* (emphasis added), are properly recorded in accordance with that Act. This section appears to draw a distinction between the meetings of committees of the board of directors and those of the company's audit committee. Thus, it supports the interpretation that the legislator contemplated an essential distinction between board committees envisioned in

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[387] S 94(2) of the Companies Act 2008.
[388] Hendrikse JW & Hefer L *Corporate Governance Handbook: Principle and Practice* 3 ed (2019) 391.
[389] S 94 of the Companies Act 2008; also see Wixley T, Everingham G & Louw K *Corporate Governance: The Directors' Guide* 5 ed (2019) 147.
[390] S 7(b)(iii) of the Companies Act 2008.

section 72 of the Companies Act 2008 and the company's independent and standalone audit committee fashioned in section 94 of the same Act, and that the latter is not to be one of the committees of the board of directors.

2.3.2 The relationship between the audit committee and the governing bodies

2.3.2.1 The audit committee and board of directors

While the board of directors is the focal point of corporate governance,[391] various corporate governance codes task the audit committee with the responsibility of overseeing the company's compliance with laws and regulations and the company's code of conduct.[392] For its part, the *King IV Code* recommends that the board of directors should apply its collective mind to the information, opinions, recommendations, reports and statements presented by the board committee.[393] It is submitted that this recommended principle also applies to the audit committee, more so as the audit committee may also serve an advisory function to the board of directors, aimed at improving performance within the company.[394] It must report its actions to the board of directors and make appropriate recommendations.[395] Some boards of directors, notably in some public entities, also delegate risk governance to a combined audit committee, named Audit and Risk Committee,[396] imaginably to leverage on the independence of the audit committee. When this happens, the audit committee is required to satisfy itself that it dedicates sufficient amount of time to that risk governance responsibility.[397]

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[391] *South African Broadcasting Corporation v Mpofu* para 9.

[392] Marx B & Els G 'The role of the audit committee in strengthening business ethics and protecting stakeholders' interests' (2009) vol. 4 No. 1 *African Journal of Business Ethics* 7.

[393] Recommended Practice 49 under Principle 8 of Part 5.3 of the *King IV Code.*

[394] Magrane J & Malthus S 'Audit Committee Effectiveness: A Public Sector Case Study' (2010) vol. 25 Iss: 5 *Managerial Auditing Journal* 427-443.

[395] Al-Mahamid SM & Al–Sa'eed 'Features of an effective audit committee, and its role in strengthening the financial reporting: Evidence from Amman Stock Exchange' (2011) vol. 1, no. 1 *Journal of Public Administration and Governance* 48.

[396] For example, in the Report of the Judicial Commission of Enquiry into Allegations of Impropriety at the Public Investment Corporation, Proclamation No. 30 of 2018 (the 'PIC Report') , it was recommended that the Risk and Audit Committees should be separated and each be a standalone committee (see para 62, pp 133 of the PIC Report).

[397] Recommended Practice 53 under Principle 8 of Part 5.3 of the *King IV Code.*

Cassim *et al* suggests that the audit committee is accountable to the board.[398] This does not, with respect, reconcile with the idea that the audit committee is an independent organ of the company as propounded above. It has been argued above that the audit committee is an independent standalone organ of the company and therefore, ought to be accountable to the shareholders in a meeting. Notwithstanding the foregoing, the audit committee should adopt a probing attitude and question the management's judgment to protect the interests of the stakeholders.[399] This highlights the importance of both the composition and structure of the audit committee,[400] its independence and the protection thereof. When the audit committee endeavours to discharge its statutory responsibilities and probe some of the board's actions, this may be perceived, by the board of directors, as not supporting the strategic direction of the company. This perception may lead to purging of members of the audit committee by the board of directors, thus interference with the independence of that committee.

In the exercise of their powers or the performance of their functions, directors, acting individually or collectively as a board, may rely on any information, opinions, recommendations, reports or statements, including financial statements and other financial data, prepared or presented by a committee of the board.[401] This includes such information, opinions, recommendations, reports[402] or statements, including financial statements and other financial data, prepared or presented by or under the direction of the audit committee. By this, directors may mitigate or even escape personal liability contemplated in section 77 of the Companies Act 2008 by invoking the business judgment rule, having relied on the advice of the company's audit committee.

The board of directors is also required to receive submission from the company's audit committee on any matter concerning the company's accounting policies, financial control, records and reporting.[403] The foregoing demonstrates the

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[398] Cassim et al *Contemporary Company Law* 3 ed (2021) 625.
[399] Ferreira I 'The effect of audit committee composition and structure on the performance of audit committees' (2008) vol. 16 no. 2 *Meditari Accountancy Research* 91.
[400] Ferreira I 'The effect of audit committee composition and structure on the performance of audit committees' (2008) vol. 16 no. 2 *Meditari Accountancy Research* 91.
[401] S 76(4)(b)(ii), read with subsection (5)(c) of the Companies Act 2008.
[402] Including reports contemplated in section 94(7)(f) of the Companies Act 2008.
[403] S 94(7)(h) of the Companies Act 2008.

significance of the relationship between the board of directors and the company's audit committee, as separate organs of the company. It is submitted that neither the board of directors nor the audit committee can effectively discharge its statutory responsibilities without the unwavering support from the other. However, such support should not compromise the independence of the audit committee.

While the legislative and regulatory framework must strive to promote a seamless working relationship between the board of directors and the company's audit committee, the need to protect the latter from the former remains sacrosanct. This is not only essential to provide oversight on behalf of the board of directors but also to enhance accountability and transparency,[404] and to improve the system of corporate governance in the interest of the company's broader stakeholder community and the society at large.

2.3.2.2 The audit committee and the accounting authority

The object of the PFMA is to secure transparency, accountability, and sound management of the revenue, expenditure, assets and liabilities of public entities.[405] This establishes the accountability of the accounting authorities of public entities and requires these accounting authorities to exercise the duty of utmost care, so as to ensure reasonable protection of the entities' assets and records.[406] The audit committee of public entities is seen as an integral part of this process of transparency, accountability and improved financial management within these entities.[407] Although the functions of audit committee of privately-owned companies (private and public) and public entities (SOEs) are generally the same, members of the audit committee of public entities face special challenges because of the uniqueness of public entities,[408] which is driven by the legislative emphasis on public interest transparency and accountability.

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[404] As evidenced by the heading of Chapter 3 of the Companies Act 2008.
[405] S 2, read with section 3(b), of the Public Finance Management Act 1 of 1999
[406] S 50(1)(a) of the Public Finance Management Act 1 of 1999; Also see Thabane T & Snyman-Van Deventer E 'Pathological Corporate Governance Deficiencies in South Africa's State-Owned Companies: A Critical Reflection' (2018) 21 *PER /PELJ* 10.
[407] van der Nest et al 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 548.
[408] van der Nest et al 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 551.

The audit committee supports accounting authorities of public entities by providing oversight on governance, risk management, and internal control practices.[409] This is achieved by offering objective advice and recommendations to accounting authorities, on whether the entity's governance, risk management, and internal control processes are suitably designed and working as intended to achieve the objectives.[410] The contribution of the audit committee strives to ensure effective accountability and transparency within the organisation, more so as there is more public interest in the governance performance of public entities than there would be, in a privately-owned company.[411]

The PFMA prescribes that the accounting authority of a public entity must ensure that the entity establishes and maintains a system of internal audit under the control and direction of an audit committee.[412] Among other things, the audit committee of a public entity is required to review the entity's compliance with legal and regulatory provisions.[413] This implies that the audit committee is required to objectively assess the efforts undertaken by the accounting authority to comply with the relevant statutory and regulatory framework applicable to the entity. In doing so, the audit committee is also required to report and make recommendations to the accounting authority.[414] The effect of this legislative arrangement is that the audit committee is expected to evaluate the accounting authority's compliance with the relevant regulatory framework and report back to the same accounting authority.

Like the relationship between the audit committee and board of directors discussed above, the relationship between the accounting authority of a public entity and the entity's audit committee may turn sour, depending on how the accounting authority, as the driving brain behind the strategic direction of the public entity, perceive the actions of the entity's audit committee in certain circumstances. This may be compounded by the fact that, as seen in recent times, most of the accounting

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[409] Global Institute of Internal Auditors 'Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations' (June 2014) 6.
[410] Global Institute of Internal Auditors 'Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations' (June 2014) 7.
[411] Global Institute of Internal Auditors 'Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations' (June 2014) 15.
[412] S 51(a)(ii) of the Public Finance Management Act 1 of 1999.
[413] Regulation 27.1.8(f) of the Treasury Regulation for PFMA.
[414] Regulation 27.1.10(a) of the Treasury Regulation for PFMA.

authorities of public entities fail to function in accordance with the requirements of the Companies Act 2008,[415] the PFMA and other relevant governance codes. Therefore, the audit committee's probing attitude, in questioning the judgment of the accounting authority, may create an unhealthy tension between the committee and the authority, especially as the accounting authority is vested with the powers to establish and appoint members of the audit committee.[416] Even more disconcerting is the fact that Treasury Regulations for PFMA envision the audit committee of the public entity as a subcommittee of the accounting authority of that entity.[417] It is submitted that the fact that the audit committee of a public entity must be appointed by the entity's accounting authority as a subcommittee of that authority is problematic to the extent that it appears to be inconsistent with Regulation 3.1.5 of the Treasury Regulations for PFMA. This highlights the need for sufficient legislative mechanisms to preserve the independence of the audit committee in public entities and its greater protection from the accounting authority.

2.3.3 The relationship between the audit committee and the shareholders

2.3.3.1 The audit committee and shareholders

A company is a 'congregation' of multiplicity of stakeholders, namely shareholders, customers, employees, suppliers, government and society.[418] Of particular significance is the relationship between shareholders of the company and the company's directors, which is fraught with conflicting interests that arise due to the separation of ownership and control, divergent management and shareholder objectives, and information asymmetry between directors and shareholders.[419] As a result of these conflicting interests, directors have the incentives and ability to maximise their own worth and advance their own interests at the expense of the

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[415] Thabane T & Snyman-Van Deventer E 'Pathological Corporate Governance Deficiencies in South Africa's State-Owned Companies: A Critical Reflection' (2018) 21 *PER /PELJ* 5. Also see Public Protector's Report No 23 of 2013/2014 entitled 'When Governance and Ethics Fail' and Report of the Judicial Commission of Enquiry into Allegations of Impropriety at the Public Investment Corporation, Proclamation No. 30 of 2018 (the 'PIC Report') 24.

[416] Regulation 27.1.1 of the Treasury Regulation for PFMA.

[417] Regulation 27.1.1 of the Treasury Regulation for PFMA.

[418] Bhasin M 'Strengthening corporate governance through an audit committee: An empirical study' (2016) vol 23 no. *2 Wulfenia Journal* 2.

[419] Bhasin M 'Strengthening corporate governance through an audit committee: An empirical study' (2016) vol 23 no. *2 Wulfenia Journal* 2.

shareholders.[420] For this reason, the audit committee plays in important role in safeguarding the interests of the shareholders, particularly by assuring accuracy, integrity and completeness of the information provided to the shareholders by the company's board of directors.[421]

The Companies Act 2008 obligates the audit committee to present its audit committee report at an annual general meeting of the shareholders.[422] It is expected that the chairperson of the company's audit committee should attend the annual general meeting, to not only present the audit committee report but also to answer the shareholders' questions regarding the company's financial statements or other related matters.[423] However, it is submitted that, as directors of the company,[424] all members of the audit committee should be available at the annual general meeting to respond to shareholders' queries on how the board of directors executed its governance duties.[425] It is through these engagements with the audit committee that shareholders can have the benefit of an independent account of the status of the company's corporate governance.

One of the statutory responsibilities of the audit committee is to recommend, through nomination, a registered independent auditor, to be appointed pursuant to the provisions of section 90 of the Companies Act 2008.[426] The independent auditor so nominated and recommended is appointed by the company's shareholders at the annual general meeting.[427] Shareholders of the company are empowered to exercise their right to vote at the shareholders' general meetings, including annual general meetings. It must be noted that, to the extent that the shareholders' agreement may provide otherwise, the shareholders are not bound by anything in law to vote in a particular way or in favour of or against a particular resolution.[428]

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[420] Bhasin M 'Strengthening corporate governance through an audit committee: An empirical study' (2016) vol 23 no. *2 Wulfenia Journal* 2.
[421] Marx B (2008) at 318.
[422] S 61(8)(a)(iii) of the Companies Act 2008.
[423] Marx B (2008) at 318.
[424] S 94(4)(a) of the Companies Act 2008 requires each member of the audit committee to be a director of the company.
[425] Recommended Practice 7 under Principle 16 of Part 5.5 of the *King IV Code.*
[426] S 94(7)(a) of the Companies Act 2008.
[427] S 61(8)(c)(i) of the Companies Act 2008.
[428] The court in *Ben-Tovim v Ben-Tovim* 2001 (3) SA 1074 (C) at 1088D-E, held that shareholders vote in respect of their shares, which are property, and the right to vote is attached to the share itself as an incident of property which may be exercised by the shareholder in his or her own

The vote is absolutely free,[429] which means that shareholders are at liberty to vote for their own individual interests. For this reason, shareholders may, at the annual general meeting, elect to appoint an auditor other than the one nominated and recommended by the audit committee, subject to the audit committee satisfying itself that such auditor is independent from the company.[430] This reduces the risk of shareholders possibly accusing the audit committee of imposing a particular choice of an auditor on the shareholders.

The foregoing demonstrates the importance of the interaction between the audit committee of the company and the company's shareholders. It helps to alleviate the shareholders' fear of what corporate governance experts refer to as the 'agency problem' or the 'agency costs' or the 'agency conflict'.[431] The role of the audit committee, through the oversight of the audit and reporting functions, helps in resolving this agency problem and assists shareholders in monitoring and controlling the company's resources.[432] It is one of the measures established to reduce the self-serving nature of the agents.[433]

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interest.

[429] See *Pender v Lushington* (1877) 6 ChD 70 at 75-76, where the court held that '…a [shareholder] may be actuated in giving his [or her] vote by interests entirely adverse to the interests of the company as a whole, but he [or she] cannot be restrained from giving his [or her] vote in what way he [or she] pleases because he [or she] is influenced by that motive. There is…no obligation on a shareholder of a company to give his [or her] vote merely with a view to what other persons may consider the interests of the company at large. [A shareholder] has a right, if he [or she] thinks fit, to give his [or her] vote from motives or promptings of what he [or she] considers his [or her] own individual interests'.

[430] S 94(9) of the Companies Act 2008.

[431] This refers to fact that directors, viewed as agents supposedly with no material interest in the company, may engage in a conduct which is to their own benefit, which conduct may be detriment to the company and its various stakeholders, collectively viewed as the principal. For detailed discussion on the agency theory, see Akwenye NJ, Chata T & Benedict OH 'Establishment of audit committee in government ministries of a developing country' (2016) 6(4) *Risk Governance & Control: Financial Markets & Institutions* 283; Thabane T & Snyman-Van Deventer E 'Pathological Corporate Governance Deficiencies in South Africa's State-Owned Companies: A Critical Reflection' (2018) 21 *PER /PELJ* 6-8; Chokuda CT *The Protection of Shareholders' Rights versus Flexibility in the Management of Companies: A Critical Analysis of the Implications of Corporate Law Reform on Corporate Governance in South Africa with specific reference to protection of shareholders* (published PhD thesis, University of Cape Town, 2017) 80-81; Zábojníková G *The Audit Committee Characteristics and Firm Performance: Evidence from the UK* (published Masters in Finance dissertation, Porto University, 2016) 3. Mupangavanhu BM (2016) 50.

[432] Bhasin M 'Strengthening corporate governance through an audit committee: An empirical study' (2016) vol 23 no. *2 Wulfenia Journal* 3.

[433] Zábojníková G (2016) 3.

From the above discussion, it appears that the audit committee does not have much interaction with the company's shareholders. On this basis, it is submitted that the audit committee does not require any protection from the shareholders, especially as the shareholders are not involved in the running of the business and affairs of the company. Other than the annual election and appointment of audit committee members by shareholders,[434] the annual presentation of the audit committee report to the shareholders by the audit committee[435] and the annual nomination of an independent auditors by the audit committee,[436] there is no other material interaction between the company's audit committee and the shareholders, unless specifically arranged by the board of directors on an *ad hoc* basis.[437]

2.3.3.2 The audit committee and the executive authority

Given the recent history of widely reported corporate governance collapses and alleged misapplication of state resources within the South African public entities, Regulation 27.1.11 of the Treasury Regulations for PFMA appears to be the most important provision that creates an oversight and accountability mechanism under the PFMA. This regulation requires the chairperson of the audit committee of the public entity to report to the executive authority and the Auditor-General, any information which implicates any member of the entity's accounting authority in fraud, corruption or gross negligence. The chairperson of the audit committee may not be the chairperson of the accounting authority or any person who performs an executive function within the public entity.[438] Although allegations of criminal conduct such as fraud and corruption should be reported to law enforcement agencies for an appropriate investigative and prosecutorial action, this regulation creates the much needed accountability mechanism envisioned by section 216 of the Constitution.[439]

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[434] S 94(2), read with section 61(8)(c)(ii) of the Companies Act 2008.
[435] S 61(8)(a)(iii) of the Companies Act 2008.
[436] S 94(7)(a) of the Companies Act 2008.
[437] In terms of section 61(1) of the Companies Act 2008, the board of a company, or any other person specified in the company's Memorandum of Incorporation or rules, may call a shareholder meeting at any time.
[438] Regulation 27.1.3 of the Treasury Regulation for PFMA.
[439] van der Nest et al 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 547. Also see *South African Broadcasting Corporation*

The Treasury Regulation for PFMA further establishes an unrestricted communication channel between the audit committee and the executive authority of the public entity. The former is required to report 'any concerns' it deems necessary to the latter.[440] Since this regulation is not prescriptive of exactly what kind of concerns the audit committee may report to the executive authority, it is submitted that the regulation gives the audit committee broader discretion to make an independent evaluation of what conduct or omission requires the attention of the executive authority. This may construct a healthy relationship and a great deal of trust between these two organs of the company, with the executive authority relying on the independence of the audit committee for unfiltered flow of material information.

Under the PFMA and the Treasury Regulations for PFMA, the executive authority of the public entity does not play any role in the establishment and configuration of the entity's audit committee. The accounting authority has the sole responsibility to establish the audit committee[441] and appoint non-executive members, who may or may not be members of the accounting authority.[442] However, if the accounting authority resolves to remove a member or members of the entity's audit committee before end of term, the executive authority of that entity must approve to such removal.[443] The removal of members of the audit committee is discussed in detail in Chapters 3 and 5 below.

2.3.4 The relationship between the audit committee and the company's creditors

The introduction of the principle of limited liability created some concerns about the position of creditors of the company.[444] This principle is one of the consequences of the principle of separate legal personality birthed by the seminal decision in

v Mpofu para 56, where the court per Jajbhay J stated that the PFMA gives effect to Chapter 13 of the Constitution.

[440] Regulation 27.1.12 of the Treasury Regulation for PFMA.

[441] Regulation 27.1.1 of the Treasury Regulation for PFMA.

[442] Regulation 27.1.4 of the Treasury Regulation for PFMA.

[443] Regulation 27.1.5 of the Treasury Regulation for PFMA.

[444] Lombard S *Directors' duty to creditors* (published LLD thesis, University of Pretoria, 2006) 3.

Salomon v Salomon & co Ltd.[445] The principle of separate legal personality recognises a company as:

> …a different person altogether from the subscribers to the memorandum and though it may be that, after incorporation, the business is precisely the same as it was before and the same persons are managers and the same hand receive profits, the company is not, in law, the agent of the subscribers or trustee for them.[446]

In South Africa, the principle of separate legal personality was first adopted in *Dadoo Ltd v Krugersdorp Municipality Council* 1920 AD 530, in which it was held that 'a registered company is a legal *persona* distinct from the members who composed it'.[447]

The common law principles of legal personality and the limited liability have been codified under section 19 of the Companies Act 2008. The Companies Act 2008 provides that a company is a juristic person from the date and time of its registration,[448] with the result that it has all the legal powers and capacity of an individual,[449] except to the extent that a juristic person is incapable of exercising any such power, or having any such capacity[450] or the company's MOI states otherwise.[451] Consequently, only the company is liable for its own liabilities, unless the company is a personal liability company[452] As a general rule, no one is, solely by reason of being an incorporator, shareholder or director of a company, liable for any liabilities or obligations of the company, except to the extent that the Companies Act 2008 or the company's MOI provides otherwise.[453] Therefore, shareholders of the company, and not the company itself, enjoy limited liability.[454] By this, it is meant that the liability of shareholders for the company's debts is limited to the amount the shareholders paid to the company for its shares.[455] As they are not liable for the

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[445] [1897] AC 22 (HL).
[446] *Salomon v Salomon & co Ltd.* [1897] AC 22 (HL) para 51.
[447] *Dadoo Ltd v Krugersdorp Municipality Council* 1920 AD 530.
[448] S 19(1)(a) of the Companies Act 2008.
[449] S 19(1)(b) of the Companies Act 2008.
[450] S 19(1)(b)(i) of the Companies Act 2008.
[451] S 19(1)(b)(ii) of the Companies Act 2008.
[452] In which case, the directors and past directors are jointly and severally liable, together with the company, for any debts and liabilities of the company as are or were contracted during their respective periods of office. See section 19(3) of the Companies Act 2008.
[453] S 19(2) of the Companies Act 2008.
[454] Cassim et al *Contemporary Company Law* 3 ed (2021) 46.
[455] Cassim et al *Contemporary Company Law* 3 ed (2021) 46.

debts of the company, shareholders are under no obligation to the company or its creditors beyond the obligation based on the value of their shares.[456]

As highlighted above, a company is, from the perspective of stakeholder-inclusivity, congregation of assortment of stakeholders.[457] This congregation includes the company's body of creditors. Creditors, like other stakeholders, are interested in the financial and non-financial information of the company and its operations.[458] It is the role of the audit committee to ensure that the company produces accurate, reliable and credible financial and non-financial reports for the benefit of the creditors and other stakeholders,[459] for the purpose of decision-making. Creditors need complete and accurate financial information to assess the financial position and liquidity of the company.[460] The failure of creditors to be able to distinguish between companies with good or bad prospects during periods of financial difficulties can result in premature liquidations.[461]

It is conceivable that creditors, like shareholders and other stakeholders, may also be troubled by the agency costs. The creditors' interests in the company arise from the creditors' contractual relationships with the company and can only be protected through the terms of the contracts they negotiate and conclude with the company.[462] Creditors rely on the stewardship of the company's board of directors to keep their interests afloat. Any breach of these contractual obligations can be remedied through the traditional remedies for breach of contract.[463] However, the poor the management, the more chances the company will fail[464] and when the company

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[456] Cassim et al *Contemporary Company Law* 3 ed (2021) 46.

[457] Bhasin M 'Strengthening corporate governance through an audit committee: An empirical study' (2016) vol 23 no. *2 Wulfenia Journal* 2.

[458] Marx B & van der Watt A 'Sustainability and integrated Reporting: An analysis of the audit committee's oversight role' vol 9 (2) *Journal for New Generation Sciences* 60.

[459] Marx B & van der Watt A 'Sustainability and integrated Reporting: An analysis of the audit committee's oversight role' vol 9 (2) *Journal for New Generation Sciences* 61.

[460] Marx B (2008) 340.

[461] Maher M & Andersson T 'Corporate governance: Effects on firm performance and economic growth' (1999) *OECD* 28.

[462] Lombard S (2006) at 13. Also see at 3; Anderson H 'Directors' Liability to Creditors - What are the Alternatives?' (2006) vol 18, 2, *Bond Law Review* 3.

[463] Lombard S (2006) 13.

[464] Aderibigbe 'Minority shareholders' right and the majority rule under corporate governance: An appraisal' 2016 (1) *JCLA* 109.

fails, creditors' contractual claims will only be against a failed company with little or no assets to satisfy the creditors' claims.[465]

As aforementioned, the business and affairs of the company are managed by or under the stewardship of the company's board of directors. The Companies Act 2008 requires the board of directors to consider the solvency and liquidity[466] position of the company in a number of transactions. For example, the board of directors is required to consider the solvency and liquidity test when transferring a foreign company to the Republic,[467] providing financial assistance for the purpose of or in connection with the subscription of any option, or any securities, issued or to be issued by the company or a related or inter-related company, or for the purchase of any securities of the company or a related or inter-related company,[468] providing financial assistance to the company's directors,[469] making any distribution,[470] capitalization of the company's shares,[471] and proposals[472] and implementation[473] for amalgamations and mergers. It is submitted that the liquidity test, which requires the company to be able to pay its debts as they become due and payable during the ordinary course of business, is intended to safeguard the interests of the creditors of the company. The role of the company's audit committee is vital for this protection.

Another protection of the company's creditors is found in section 22(2) of the Companies Act 2008, which deters the company from trading when it is unable to pay its debts as they become due and payable in the normal course of its business[474]. If the CIPC has reasonable grounds to believe that a company is unable to pay its debts as they become due and payable in the normal course of business, it may issue a notice to the company to show cause why the company should be

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[465] See Cassim et al *Contemporary Company Law* 3 ed (2021) 67-51. The property, assets, profits, debts and liabilities of the company belong to the company and except in exceptional circumstances, shareholders of the company cannot be compelled to pay the debts of the company. Such exceptional circumstances include the piercing of the corporate veil or where a shareholder has given guarantees or a security.

[466] The tests for Solvency and Liquidity of the company are set out in section 4 of the Companies Act 2008.

[467] S 13(6)(f)(i) of the Companies Act 2008.

[468] S 44(3)(b)(i) of the Companies Act 2008.

[469] S 45(3)(b)(i) of the Companies Act 2008.

[470] S 46 of the Companies Act 2008.

[471] S 47(2)(a) of the Companies Act 2008.

[472] S 113 of the Companies Act 2008.

[473] S 116 of the Companies Act 2008.

[474] Cassim et al *Contemporary Company Law* 3 ed (2021) 800.

permitted to continue carrying on its business, or to trade.[475] If the company fails to satisfy the CIPC that it is able to pay its debts as they become due and payable in the normal course of business, the CIPC is empowered to issue compliance notice to the company requiring it to cease carrying on its business or trading.[476] Cassim *et al* views this as a novel and modern approach to the protection of the company's creditors and the general public.[477] Such protection may only be realised if the audit committee plays an active role in ensuring that the company, under the direction of the board of directors, complies with the provisions of section 22 of the Companies Act 2008 and other statutory and regulatory provisions.

Like the shareholders, the creditors of the company do not have any powers in relation to the management of the business and affairs of the company. They only rely on the financial information and performance of the company, and the company's compliance with the relevant statutory and corporate governance codes to make decisions. They are reliant on the oversight role of the audit committee, to give guidance and reasonable assurance in relation to the integrity, completeness and accuracy of the financial reports. It is for this reason that there is a greater need for the independence of the audit committee to be sufficiently protected from those who are enjoined with the powers to manage the company's business and affairs. A compromised audit committee may increase the risk of poor corporate governance practices, fraudulent financial reporting, creative accounting and auditor inefficiency, which may, in turn, negatively impact on the interests of the company's body of creditors.

2.3.5 The relationship between the audit committee and the company's auditors

The Companies Act 2008 requires annual financial statement of certain companies to be audited.[478] In terms of section 30(2)*(a)*, the annual financial statements of a public company must be audited. This includes public entities. For any other company, the annual financial statements must be audited only if that company is

[475] S 22(2) of the Companies Act 2008.
[476] S 22(3) of the Companies Act 2008.
[477] Cassim et al *Contemporary Company Law* 3 ed (2021) 801.
[478] Cassim et al *Contemporary Company Law* 3 ed (2021) 816.

obligated in terms of the Company Regulations 2011[479] or voluntarily in terms of the company's MOI or shareholders' resolution.[480] The Companies Act 2008 defines the term audit with reference to the Auditing Profession Act 26 of 2005 ('the Auditing Profession Act').[481] It involves comprehensive testing to gather sufficient appropriate audit evidence for the auditor to express an opinion on the fair presentation of the company's financial statements.[482] Such auditor's opinion must be included in the company's audited annual financial statements.[483]

A public company must convene an annual general meeting of its shareholders to, among others, receive presentation of the company's audited financial statements for the immediately preceding financial year[484] and appoint the company's auditor for the ensuing financial year.[485] Further, any other company which is obliged under the Companies Act 2008 or Companies Regulations 2011 or its MOI to have its financial statements audited must appoint an auditor in terms of the provisions of section 90(1A) of the Companies Act 2008. It must be noted that an auditor appointed under the Companies Act 2008 or Companies Regulations 2011 must be an auditor nominated and recommended for appointment by the company's audit committee.[486] The shareholders are at liberty to elect to appoint an auditor other than the one nominated and recommended by the company's audit committee. However, such appointment is valid only if the audit committee is satisfied that the auditor is independent of the company. [487]

The role of the audit committee in the appointment of the company's auditor is aimed at fortifying and ascertaining the auditor's independence. The Companies Act 2008

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[479] S 30(2)(b)(i) of the Companies Act 2008. Regulation 28(2) of the Companies Regulations 2011 makes provision for the categories of companies which are required to have their annual financial statements audited.
[480] S 30(2)(b)(ii)(aa) of the Companies Act 2008.
[481] S 1 of the Companies Act 2008. Section 1 of the Auditing Profession Act 26 of 2005 defines 'audit' as examination of, in accordance with prescribed or applicable auditing standards (a) financial statements with the objective of expressing an opinion as to their fairness or compliance with an identified financial reporting framework and any applicable statutory requirements; or (b) financial and other information, prepared in accordance with suitable criteria, with the objective of expressing an opinion on the financial and other information.
[482] Cassim et al *Contemporary Company Law* 3 ed (2021) 818.
[483] S 30(3)(a) of the Companies Act 2008.
[484] S 61(8)(a)(ii) of the Companies Act 2008.
[485] S 61(8)(c)(i), read with section 90(1) of the Companies Act 2008.
[486] S 94(7)(a) of the Companies Act 2008.
[487] S 94(9) of the Companies Act 2008.

makes an express statement for the criteria to be used by the audit committee to determine the independence of the company's auditor.[488] It is submitted that it would be a corporate governance ignominy if the body, being the audit committee, responsible for strengthening, ascertaining and protecting the independence of another body, being the registered auditor,[489] is itself not independent. In exercising its financial reporting oversight role, the audit committee places a considerable amount of reliance on the independence and objectivity of the company's independent auditor.[490] It is for this reason that the audit committee should meet, without the presence of the board of directors, regularly with the company's auditor to discuss, among others, concerns which may not be appropriate to discuss in the presence of the board of directors.[491] The purpose is to avoid any possible tension or undue pressure between, on the one hand, the board of directors and, on the other hand, the audit committee and the auditor, especially if the auditor raises concerns which implicate some members of the board of directors or the board as a whole.

The audit committee's interaction with the internal and external auditors is also important to provide the committee with useful information to assess the company's ethical practices and corporate governance compliance.[492] The relationship between the audit committee and the company's auditors is based on shared objective regarding the financial affairs of the company,[493] for the benefit of the company and all its stakeholders. The primary purpose of auditing the company's financial statements is to report on the stewardship of the directors to the shareholders as a body, in order to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided.[494] Therefore, though auditors are accountable to

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[488] S 94(8) of the Companies Act 2008.
[489] Appointed in terms of section 90 of the Companies Act 2008.
[490] Marx B & Els G 'The role of the audit committee in strengthening business ethics and protecting stakeholders' interests' (2009) vol. 4 No. 1 *African Journal of Business Ethics* 8.
[491] Recommended Practice 58 under Principle 8 of Part 5.3 of the *King IV Code.*
[492] Marx B & Els G 'The role of the audit committee in strengthening business ethics and protecting stakeholders' interests' (2009) vol. 4 No. 1 *African Journal of Business Ethics* 7.
[493] van der Nest et al 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 551.
[494] *Hlumisa Investment Holdings (RF) Ltd and Another v Kirkinis and Others* (1423/2018) [2020]

shareholders collectively in a meeting,[495] it is the responsibility of the audit committee to ensure that the audit process undertaken by the company's auditors functions effectively[496] and independently.

2.4 CONCLUSION

This chapter has introduced and discussed a number of key theoretical concepts relating to the scheme of corporate governance, with particular focus on the board of directors of the company, shareholders, accounting authorities, executive authorities and the audit committee. As demonstrated above, directors of the company, acting individually or collectively as a board, are central and hold the key to good and sound corporate governance. The court in *South African Broadcasting Corporation v Mpofu*[497] put it succinctly and precisely thus: 'the central issue of corporate governance is the accountability of senior management and the board of a company because of the extensive powers vested in them'.[498] As demonstrated in the succeeding chapters, this centrality of the role of directors and the board in the success of the company's corporate governance also extend to members of the company's audit committee in their capacity as (a) directors of the company and (b) more importantly, as members of the company's audit committee.

It has also been shown in this chapter that the shareholders of the company play minimal, yet an important, role in the scheme of corporate governance. Through exercising of their right to vote or not to vote at shareholders meetings, shareholders have an opportunity to hold directors of the company to account. The Companies Act 2008 makes provision for a number of mechanisms to hold directors of the company to account, such as the removal of a director in terms of section 71(1) or to hold directors personally liable in terms of section 77. The shareholders of the company also hold important powers to, *inter alia*, fill vacancies on the board of directors in terms of section 70(3)*(b)* and the powers to approve the disposal of all

ZASCA 83 (03 July 2020) para 67.

[495] *Hlumisa Investment Holdings (RF) Ltd and Another v Kirkinis and Others* (1423/2018) [2020] ZASCA 83 (03 July 2020) para 67.

[496] van der Nest et al 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 551.

[497] (A5021/08) [2009] ZAGPJHC 25; [2009] 4 All SA 169 (GSJ) (11 June 2009).

[498] *South African Broadcasting Corporation v Mpofu* para 28.

or greater part of the company's assets or undertaking in terms of section 112(2)*(a)*. As exemplified in the succeeding chapters, the powers of shareholders play a significant role in the company corporate governance, particularly in relation to the configuration of the company's audit committee. Through the exercise of these powers, shareholders may determine the extent of audit committee independence and the protection thereof.

What was also exhibited in this chapter is the relationship between the audit committee and executive authorities in public entities. In this regard, what is fundamental to this study is the salient fact that the accounting authority of a public entity is the only body with powers to establish and configure the entity's audit committee. Configuration in this context must be understood to include appointment and removal of members of the audit committee. It demonstrated in the next chapters why this is problematic, in so far as the protection of the independence of the audit committee in public entities is concerned. For its part, the executive authority must concur with any premature termination of services of a member of the audit committee[499] and has powers to approve certain significant transactions of the public entity.[500]

This chapter has also discussed the important role played by the audit committee in corporate governance. Among others, an effective audit committee enhances compliance with corporate governance legislative and regulatory framework by the board of directors. As a watch dog, the audit committee assures accurate and reliable financial reporting, effective risk management and internal control system and independent audit functions. Therefore, in order to mitigate against possible corporate fraud or creative accounting practices, the audit committee must not only be independent from the company's board of directors and management but also its independence must also be protected.

The importance of the work of the company's audit committee cannot be emphasised enough. As demonstrated in Chapter 1, the whole philosophy behind corporate governance revolves around the directors of the company executing their

[499] Regulation 27.1.5 of the Treasury Regulation for PFMA.
[500] S 54(2) of the Public Finance Management Act 1 of 1999.

directorial duties in the manner which is consistent with the statutory framework and applicable regulatory codes, for the benefit of the company and its stakeholders. This chapter has provided an exposition of how the company's body of stakeholders relies, to a greater degree, on the independent work of the company's audit committee.

This chapter has also examined the relationship between the audit committee of the company and the company itself. While many leading experts in the domain of corporate law appear to be in favour of the view that the audit committee is a committee or subcommittee of the company's board of directors, it has been argued, in this chapter, that the correct and perhaps more purposive interpretation points to the audit committee as being a standalone organ of the company. The fact that the audit committee reports to the company's board of directors does not, by itself, mean that it is a subcommittee of the board. The audit committee derives its power of existence and statutory duties from the Company's Act 2008 and the relevant other statutory and regulatory frameworks governing a particular type of company, such as the public entity. These statutory duties may be supplemented by duties delegated by the company's board of directors. The establishment, the powers to establish and maintain the audit committee is a controversial issue *vis-à-vis* the independence of the audit committee, which is discussed in the next chapters.

The relationship between the audit committee and the company's governing body, that is the board of directors under the Companies Act 2008 and accounting authority under the PFMA, is most crucial one. More so as some of the well-known corporate scandals and governance failures, both locally and internationally, took place under the watch of audit committees in most of the companies.[501] There is convergence that both the board of directors and the audit committee play a significant role in the faculty of corporate governance and financial reporting, with the latter being more crucial for the integrity, completeness and accuracy of the information provided to the company's stakeholders. Therefore, the audit committee must be afforded a clear and solid independence from the company's board of

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[501] Marx B (2008) 10.

directors, to execute its statutory and any other delegated functions without undue influence.

For the shareholders of the company, the agency costs anguish may be too much to bear in circumstances where the company's audit committee behaves as if it is the public relations arm of the company's board of directors. The stakeholders of the company must have confidence in the work of the audit committee, to strengthen their stakeholding enterprise. As propounded in Chapter 5 of this thesis, an independent oversight of the audit functions and financial reporting of the company cannot be perceived to be independent when the body tasked with such oversight is, itself, not independent. Accurate and complete financial reports may assist the companies' shareholders and executive authorities of public entities to make informed and responsible investment[502] decisions.

In the next chapter the relevant provisions dealing with the establishment and composition of the company's audit committee are evaluated. The focus is specifically on the appointment and removal of members, as well as the role, functions and duties of the audit committee, to highlight the weaknesses in the manner in which the company's audit committee is configured and maintained. It is argued that the provisions of the Companies Act 2008 and the PFMA do not sufficiently provide for protection of the audit committee in respect of the critical work it performs.

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[502] See *King IV Report* (2016) at 16, where *'responsible investment'* is defined as an approach to investment which is aimed at incorporating environmental, social and governance factors into investment decision-making, to better manage risk and generate sustainable long-term returns.

CHAPTER 3: AUDIT COMMITTEES IN SOUTH AFRICA – CONSTITUTION, APPOINTMENT, ROLE, DUTIES, REMOVAL OF MEMBERS AND THE EFFECT ON INDEPENDENCE

3.1 INTRODUCTION

As it was demonstrated in Chapter 2, the audit committee has become a critically important corporate governance improvement mechanism, in light of the fact that South Africa has experienced an assortment of corporate scandals and financial irregularities. For the South African corporate community, the stakeholders are expected to increasingly become more reliant on the role of the audit committee.[503] This is not only for the provision of oversight on companies' financial reporting but also for ensuring that the board of directors and board subcommittees do not abuse the powers conferred on them by Companies Act 2008, the companies' constitutive documents and the relevant corporate governance codes.

In this chapter, the provisions of the Companies Act 2008 and the PFMA relating to the establishment and composition of the audit committee are analysed. As the theme of this thesis revolves around the independence of the audit committee and the protection thereof, this analysis assists to identify gaps in the constitution of the audit committee which may potentially compromise the independence of the committee. The analysis examines the legislative and regulatory requirements for the size of the audit committee and the qualifications, skills and expertise of members of the committee, to highlight some complexities and dependencies which may strengthen or weaken the audit committee. It is shown how the corporate power dynamics may have a devastating effect on the composition of audit committee and consequently erode its independence. Further, this chapter also evaluates the maintenance of the institution of the audit committee, with particular focus on the appointment and filling in of vacancies, as well as suspension or removal of members of the committee. It is demonstrated in this chapter that the appointment

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[503] This expectation is drawn from the fact that stakeholders are the consumers of financial reports and that the audit committee provides oversight over the integrity of the financial reporting process. S94(2) of the Companies Act 2008 makes it mandatory for public companies and SOEs (and any other company mandated by its MOI) to establish audit committees. Additionally, establishment of audit committees is the Johannesburg Stock Exchange Listing Requirement (see Requirements 3.84 of the JSE Listing Requirements).

and removal or suspension of members of the audit committee has a direct and significant effect on the independence of the committee.

Chapter 3 also provides a detailed exposition of the functions and duties of the audit committee. The role, functions and duties of the audit committee are divided in this chapter into two focus areas, namely the statutory functions and duties of the audit committee under the Companies Act 2008 and the PFMA on the one hand and other functions and duties which may be delegated to the audit committee by the governing bodies (board of directors and accounting authorities) on the other hand. The segmentation is for expositional purposes and does not signify the significance of any functions and duties over others. The purpose of this discussion in this chapter is to, first, highlight the importance of the holistic role of the audit committee and, second, to further demonstrate that, because of the significance of the role it plays, the audit committee is susceptible to undue influence or interference by internal and external individuals or interest groups.

The objective of this chapter is to highlight that, for the audit committee to function independently and effectively, its members must discharge their statutory and delegated duties without fear or favour. It is argued in this chapter, that the audit committee members must not be beholden to the individuals or body which nominated or appointed them. At the conclusion of this chapter, it will be more perspicuous that the establishment and maintenance of the audit committee is not a mere tick-box exercise. The audit committee is an important corporate governance enterprise, whose independence and protection thereof cannot be compromised. The protection is indispensable for the audit committee to discharge its statutory and delegated responsibilities without any fear of victimisation of its members and consequently, to stimulate sound corporate governance for the benefit of the companies' congregation of the stakeholders.

3.2 THE COMPOSITION, APPOINTMENT, REMOVAL OF MEMBERS OF THE AUDIT COMMITTEE AND EFFECT ON INDEPENDENCE

3.2.1 The establishment and composition of the audit committee

A public company, a state-owned company or a company which is required by its MOI to establish an audit committee is obligated to establish such committee in terms of the Companies Act 2008.[504] If the company is a public entity, the establishment of the audit committee must also be in compliance with the provisions of the PFMA.[505] The composition of the company's audit committee plays the most important role in the independence of that committee. A capable, balanced, independent and committed audit committee can make a significant difference in both private and public sectors, by ensuring effective accountability and transparency.[506] The manner in which the company's audit committee is established and structured has a direct effect on the efficiency and effectiveness of its oversight function, which is critical to, first and foremost, advance the best interests on the company[507] and additionally to meet the needs of the stakeholders.[508] Among others, the key factor of the company's audit committee is the independence and objectivity of individual members of the committee and the selection process and appointment of new members.[509] Another critical factor is that members of the audit committee should be diverse and should come from complementary backgrounds.[510]

Ideally, the company's audit committee structure and composition should be determined and reviewed regularly to identify any necessary changes in the

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[504] S 94(3), read with s 94(2) of the Companies Act 2008.

[505] S 77 of the Companies Act 2008, read with Regulation 27.1.1 of the Treasury Regulation for PFMA.

[506] Global Institute of Internal Auditors 'Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations' (June 2014) 15.

[507] As directors of the company, members of the audit committee are required act in the best interest of the company in terms of s 76(3)(b) of the Companies Act 2008.

[508] Ferreira I 'The effect of audit committee composition and structure on the performance of audit committees' (2008) vol. 16 no. 2 *Meditari Accountancy Research* 90.

[509] Morgan I 'A formalised performance assessment process to improve audit committee performance in South Africa: a conceptual exploration' (2010) vol 14, no 2, *Southern African Business Review* 98.

[510] Morgan I 'A formalised performance assessment process to improve audit committee performance in South Africa: a conceptual exploration' (2010) vol 14, no 2, *Southern African Business Review* 98.

committee's membership.[511] The purpose of regular review of the audit committee membership is to assess the independence of the individual members and committee as a whole. However, to ensure effectiveness of the committee, a proper balance should be struck between the need for institutional memory and an undesirable longevity. In other words, while it may be necessary to maintain institutional memory by continuously reappointing some members on the company's audit committee, it is also essential not to keep individuals too long in the committee to become vested in the company's policies and strategic direction.[512]

In addition to the requirement to comply with the provisions of section 94(5) of the Companies Act 2008 and Regulation 42 of the Companies Regulations 2011, all members of the audit committee are required to be directors of the company.[513] Such members of the audit committee should be independent non-executive directors,[514] who are not involved in the day to day management of the company's business and have not been involved at any time during the preceding financial year.[515] The Companies Act 1973 specifically provided that the audit committee must consist of non-executive directors of the company who must act independently.[516] Interestingly, the Companies Act 2008 does not specifically use similar wording in section 94(4). Nevertheless, the reason members of the company's audit committee are required to be directors of the company is presumably for the companies to benefit from the high standard of conduct expected from directors. Another reason could be that in case of breach of statutory and common law duties, these directors will be held liable in terms of the Companies Act 2008. For example, as directors of the company, members of the audit committee are required to act in the best interests of the company[517] and their conduct must be

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[511] Ferreira I 'The effect of audit committee composition and structure on the performance of audit committees' (2008) vol. 16 no. 2 *Meditari Accountancy Research* 92; Morgan I 'A formalised performance assessment process to improve audit committee performance in South Africa: a conceptual exploration' (2010) vol 14, no 2, *Southern African Business Review* 100.

[512] Global Institute of Internal Auditors 'Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations' (June 2014) 11.

[513] S 94(4)(a) of the Companies Act 2008.

[514] Recommended Practice 56 under Principle 8 of Part 5.3 of the *King IV Code;* Also see Delport P *Henochsberg's Commentary on the Companies Act 71 of 2008* (2017) 359.

[515] S 94(4)(b)(i) of the Companies Act 2008.

[516] S 269A(3) of the Companies Act 1973.

[517] See s 76(3)(b) of the Companies Act 2008; Cassim et al *Contemporary Company Law* 3 ed (2021) 693.

consistent with the statutory provisions set out in sections 75 and 76 of the Companies Act 2008, as well as their common law fiduciary duties. Members of the audit committee, like any other director of the company, may be held personally liable under the Companies Act 2008,[518] when they fail to observe and uphold the statutory provisions or common law fiduciary duties or any other rules as set out in the company's rule and MOI.

From the foregoing, it is not clear, not least from the reading of section 94(4)*(a)* of the Companies Act 2008, whether for a person to qualify to be appointed as a member of the company's audit committee, such person must first be a director of the company, or whether a non-director can be appointed as a member of the company's audit committee and only become a director upon appointment. Nonetheless, it is submitted that any individual, who is not a director of the company and who is not ineligible or disqualified from appointment as a director of the company,[519] may be appointed to the company's audit committee and thus become a director of that company upon such appointment.[520] The reason for this is that, a purposive interpretation of section 94(4)*(a)* would show that the legislative intention of that section is not to disqualify non-directors from appointment to the company's audit committee. Instead, it is aimed at holding to the high standard of conduct, duty and liability of directors, any person appointed to the audit committee. In this regard, a recommendation is made in Chapter 6 on how this position may be clarified in section 94 of the Companies Act 2008.

The persons prohibited from serving as members of the company's audit committee include prescribed officers or full time employees of the company or its related or inter-related company or anyone having been such a prescribed officer or full time employee at any time during the previous three financial years.[521] It is rather strange, though, that the Companies Act 2008 precludes, from serving as members of the audit committee, only full time employees. It is submitted that 'part time

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[518] S 77 of the Companies Act 2008.

[519] S 69 of the Companies Act 2008 makes provision of ineligibility and disqualification of certain persons from being appointed as directors of the company.

[520] This is in light of the provisions of s 76(1)(b) and s 77(1)(b) of the Companies Act 2008, which regard members of the audit committee as directors of the company for the purpose of directors' duties and liability.

[521] S 94(4)(b)(ii) of the Companies Act 2008.

employees’ and ‘independent consultants’, who do not necessarily provide services to the company or its related or inter-related company on a full time basis, could equally have direct or indirect undue influence on or directly or indirectly be unduly influenced by the management or the governing body of the company or its related or inter-related company. Therefore, the prohibition of only full time employees does not appear to have rational basis. It is also uncertain, from the reading of the provisions of section 94(4)(b)*(ii)* of the Companies Act 2008, whether the reference to ‘full time employees’ captures within the ambit of that section only full time employees who have executive powers, though Delport[522] appears to suggest, quite correctly, that to be the case. Even so, the fact that a member of the audit committee must be an independent non-executive director of the company, who is not involved in the day to day management of the company, suggests that a member cannot be a full time employee with executive powers. Only directors involved in the day to day management of the company are full time employees of the company, vested with executive powers. It is submitted that the lawmakers should have phrased the wording of subsection (4)(b)*(ii)* to include *all types of employees*, including any person who, although he or she is not classified as an employee, nevertheless provides services to the company as if he or she was an employee.

Section 94(4)(b)*(iii)* of the Companies Act 2008 disqualifies, from serving as a member of the company’s audit committee, any person who is a material supplier or customer of the company in the circumstances where a reasonable and informed third party could be led to conclude that the integrity, impartiality or objectivity of that material supplier or customer is compromised by his or her relationship with the company. It would, therefore, appear that the provisions of subsection (4)(b)*(iii)* necessitate a two-staged enquiry. The first question is whether or not the director is a material supplier or customer of the company. If the answer is in the affirmative, then the second question arises, that is whether, objectively viewed, a reasonable and informed third party would conclude that the directors’ integrity, impartiality or objectivity is compromised. On this basis, it means that the fact that a director is a material supplier or customer of the company does not, *per se*, preclude such

[522] Delport P *New Entrepreneurial Law* 2 ed (2021) 201.

director from appointment as a member of the company's audit committee.[523] It is clear that both the first and the second questions must be answered in the affirmative. For the purpose of completeness, it must also be highlighted that any person who is related to any of the persons prohibited in terms of subsection (4)(b) is also prohibited from appointment as member of the company's audit committee.[524]

For public entities, not all members of the audit committee need to be members of the entity's accounting authority (the board of directors of the public entity).[525] However, the majority of members of the entity's audit committee must be non-executive members[526] and the chairperson must be an independent person who may not be the chairperson of the entity's accounting authority or a person who fulfills an executive function in the entity.[527] It is rather bothersome that the Regulation 27.1.3 of the Treasury Regulations for PFMA only prescribes that the chairperson of the audit committee *may not* be the chairperson of the entity's accounting authority. In an environment where legislative and regulatory provisions are often interpreted to suit a particular political or socio-economic narrative, this may be construed to mean that the entity's accounting authority may, with a plausible reason, appoint its chairperson as the chairperson of the entity's audit committee. Interestingly, the Companies Act 2008 is completely silent on whether the chairperson of the company's board of directors, who is an independent non-executive director of the company, may serve as a member of the company's audit committee. Despite the foregoing, the *King IV Code* recommends that the chairperson of the governing body should not be a member of the audit committee.[528] The reason for this is that the chairperson of the governing body plays a strategic and comprehensive role in guiding the governing body and thus, cannot simultaneously objectively lead the audit committee.[529]

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[523] Delport P *Henochsberg's Commentary on the Companies Act 71 of 2008* (2017) 358.
[524] S 94(4)(c) of the Companies Act 2008.
[525] Regulation 27.1.4 of the Treasury Regulation for PFMA.
[526] Regulation 27.1.4 of the Treasury Regulation for PFMA.
[527] Regulation 27.1.3 of the Treasury Regulation for PFMA.
[528] Recommended Practice 36.a under Principle 7 of Part 5.3 of the *King IV Code.*
[529] Cassim et al *Contemporary Company Law* 2 ed (2012) 490.

3.2.1.1 Size of the audit committee

In the case of the composition of the company's audit committee, size does matter. In determining the size of the company's audit committee, it is important to take into account the size and complexity of the company, whether the company is a public or private company and responsibilities and expertise required of the audit committee.[530] Although there is no generally prescribed or recommended maximum number of members of the company's audit committee, many company legislation and governance codes, particularly from common law jurisdictions, prescribe a minimum of three members of the audit committee. For example, the Indian Companies Act 18 of 2013 provides that the audit committee must consist of a minimum of three directors with independent directors constituting the majority.[531] In Canada, that country's legislation regulating business corporations prescribes that a corporation shall have an audit committee consisting of not less than three directors of that corporation, majority of whom must not be officers or employees of that corporation or its affiliates.[532] As Chapter 4 will reveal, the UK Companies Act 2006 does not make an express provision of the system of the audit committee. However, that jurisdiction's corporate governance code prescribes that the company's board of directors should establish an audit committee of independent non-executive directors, with a minimum membership of three, or in the case of smaller companies, two.[533]

The Companies Act 2008 prescribes that the audit committee of a public company, a state-owned company or a company which is required by its MOI to have an audit committee must comprise of a minimum of three members.[534] Under the PFMA, an audit committee of a public entity must also consist of at least three persons.[535] Ideally, the audit committee must have enough members to embody a multiplicity of skills and expertise required. While the ideal audit committees generally have between three and eight members, it is suggested that a typical audit committee

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[530] Global Institute of Internal Auditors 'Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations' (June 2014) 10.
[531] S 177(2) of the Indian Companies Act 18 of 2013.
[532] S 171(1) of the Canada Business Corporations Act of R.S.C., 1985, c. C-44.
[533] Provision 24 of the Financial Reporting Council's *UK Corporate Governance Code* 2018 10. Also see Zábojníková G (2016) 9.
[534] S 94(2) of the Companies Act 2008.
[535] S 77(a) of the Public Finance Management Act 1 of 1999.

would have four to five members.[536] The smaller the size of the audit committee in relation to the size and nature of the company, the higher the likelihood of that audit committee becoming thin on the diversity of skills and expertise, as well as complementary backgrounds. Conversely, while an increased number of members of the audit committee may provide more efficient oversight, a bigger and bloated audit committee may lack the necessary efficacy.[537]

To entrench and protect their independence, it is submitted that audit committees should not have the bare minimum number of members. To illustrate this point, the independence of an audit committee consisting of only three members, including the chairperson of the committee, may easily be weakened by unduly influencing one of the members, particular the chairperson of the committee who may be a dominant member of the committee. Whereas, where the audit committee comprises between five and eight members, for example, it may be difficult to unduly influence enough members in a manner that the majority of the committee members become sympathetic to a particular improper cause. Whatever the size of the audit committee may be, the ultimate goal should be that the audit committee consist of an adequate number of members to sustain its independence and effectiveness.

3.2.1.2 Qualifications, skills and expertise

The Companies Act 2008 requires that all members of the company's audit committee be the directors of the company,[538] who meet the requirements set out in section 94(5) of that Act. This section gives the Minister the powers to prescribe the minimum qualification requirements for members of the company's audit committee, to ensure that the committee, viewed as a whole, has adequate knowledge and experience to perform its statutory and delegated functions. Accordingly, Regulation 42 of the Companies Regulations 2011 prescribes that at least one-third of the members of the company's audit committee must, at any given time, have academic qualifications or experience in the field of economics, law, corporate governance, finance, accounting, commerce, industry, public affairs or

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[536] Global Institute of Internal Auditors 'Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations' (June 2014) 10.
[537] Zábojníková G (2016) 9.
[538] S 94(4)(a) of the Companies Act 2008.

human resources management. Recommended practice 55 under Principle 8 of *King IV Code* further recommends that, when considering the qualifications of the audit committee, members should, when viewed as a whole, have the necessary financial literacy, skills and experience to execute their duties effectively.[539] The provisions of section 94(5) of the Companies Act 2008, read with Regulation 42 of the Companies Regulations 2011, appear to be aimed at the enhancement of the effectiveness of the audit committee. It does this by evaluating the audit committee as a whole, to determine whether it has the capacity (knowledge and experience) to discharge its legislative responsibilities. The PFMA only requires majority of members of audit committees of public entities to have financial literacy.[540]

With the only statutory requirement seemingly being that of compliance with the provisions of section 94(5) of the Companies Act 2008 and Regulation 42 of the Companies Regulation 2011, it would appear that members of the audit committee need not be members of professional bodies, for example, registered auditors or accountants or attorneys. It follows, therefore, that, though the audit committee provides oversight on the auditors of the company and the audit function, the provisions of the Auditing Profession Act do not apply to members of the company's audit committee. However, there is no doubt that, where an individual member of the company's audit committee is a registered auditor as defined in the Auditing Profession Act,[541] such registered auditor is regulated as contemplated in that Act. Similarly, where a member of the audit committee is an attorney or an accountant, the member will be regulated in terms of the professional ethics and code of conduct applicable to that profession.

It is worth noting that the Companies Act 2008 or the *King IV Code* does not prescribe or recommend the level of academic qualification required for individual members of the company's audit committee. The only requirement is that one-third of the committee must possess academic qualifications or experience in the field of economics, law, corporate governance, finance, accounting, commerce, industry, public affairs or human resources management.[542] The danger with this is that the

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[539] Delport P *Henochsberg's Commentary on the Companies Act 71 of 2008* (2017) 358.
[540] Regulation 27.1.4 of the Treasury Regulation for PFMA.
[541] S 1 of the Auditing Profession Act 26 of 2005.
[542] Regulation 42 of the Companies Regulations 2011.

audit committee of the company could be constituted with only the requisite minimum number of members, with one member having academic qualification in, for example, human resources management and the other two being political activists or politically connected individuals with neither formal academic qualifications nor experience in any field. In this example, the audit committee would meet the requirements of the provisions of the Companies Act 2008 and the Companies Regulations 2011 but would not necessarily be sufficiently staffed to discharge its statutory and delegated responsibilities, and may thus be susceptible to undue influence. However, the academic qualifications and the number of years of relevant experience may be regulated by the individual company's MOI or rules. The position under the PFMA is even more disconcerting, as only the chairperson of the audit committee of the public entity is required to have business, financial and leadership skills.[543] It is submitted that the effective functioning and independence of the audit committee could be greatly improved if all (not only a minimum of one-third) members of the committee are required to meet the prescribed academic qualification requirements. A recommendation in this regard is made in Chapter 6.

3.2.1.3 Powers of the audit committee

It would be inappropriate and even misleading to refer to and draw a distinction between statutory audit committees and voluntary audit committees. The reason for this is that once an audit committee has been established, whether mandatorily under the Companies Act 2008 and the PFMA in the case of public entities or voluntarily in terms of the company's MOI, it derives its original or primary powers from the Companies Act 2008, the PFMA or the company's MOI, as the case may be. The audit committee may also derive secondary powers from delegated functions from the governing bodies. In other words, no audit committee could be said to be more empowered by reason that the company was obliged by the Companies Act 2008 or PFMA to establish that audit committee or less empowered by reason that, that audit committee was established voluntarily in terms of the company's MOI. As a constitutive document, company's MOI has the same binding effect as the Companies Act 2008 and the PFMA, albeit as between the directors

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[543] Regulation 27.1.3 of the Treasury Regulation for PFMA.

inter se, the company and its directors, the directors and shareholders, the shareholders and the company and the shareholders *inter se*. These relationships are governed by the Companies Act 2008 and the company's MOI.[544]

The audit committee should have the powers to make independent decisions regarding its statutory duties and is accountable for its performance in this regard.[545] Neither the Companies Act 2008 nor *King IV Code* sheds some light as to whether the audit committee is accountable to the board of directors or the shareholders. For the subscribers to the idea that the audit committee is a subcommittee of the company's board, the argument would be made that the audit committee is accountable to the board. However, as emphatically argued in Chapter 2 of this thesis, the audit committee cannot possibly be the committee of the company's board of directors. For this reason, it is submitted that the company's audit committee is or should be accountable to the company's shareholders in the meeting. It will be demonstrated in Chapter 5 of this thesis that the independence, the powers and performance of the audit committee which is accountable to the company's board of directors will likely be greatly compromised.

In terms of the Companies Act 2008, the audit committee has the powers to determine audit fees[546] and to pre-approve any proposed agreement with the auditor for the provision of non-audit services.[547] The audit committee also has the powers to make a determination as to the nature and extent of non-audit service the auditor may or may not provide to the company.[548] Under the PFMA, the audit committee of the public entity has the authority to investigate matters within its powers, as identified in the written terms of reference.[549] More crucially, the audit committee of the public entity has the authority to review the entity's compliance with legal and regulatory provisions.[550] This appears to be another mechanism to provide oversight over the entity's accounting authority on behalf of the entity's executive authority, as

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[544] See s 15(6) of the Companies Act 2008.
[545] Recommended Practice 52 under Principle 8 of Part 5.3 of the *King IV Code.*
[546] S 94(7)(b) of the Companies Act 2008.
[547] S 94(7)(e) of the Companies Act 2008.
[548] S 94(7)(d) of the Companies Act 2008.
[549] Regulation 27.1.8(f) of the Treasury Regulation for PFMA.
[550] Regulation 27.1.9 of the Treasury Regulation for PFMA.

well as promoting transparency and accountability for the benefit of the general public.

3.2.2 Appointment of members of the audit committee under the Companies Act 2008

The manner in which members of the company's audit committee are appointed has a direct consequence on the committee's independence and protection thereof. To safeguard its independence, the audit committee should not be staffed with individuals who are beholden to the people who nominated them for appointment or who appointed them.[551] Though the aforesaid may practically be inescapable, the provisions regulating the appointment of members of the audit committee must be stricter to mitigate against such eventuality. The widespread corporate governance failures and financial irregularities scandals in South African private sector corporations and major public entities suggest that the corporate law principle of directors' personal liability has not served as deterrence for errant directors. Therefore, the fact that members of the companies' audit committees are regarded as or required to be directors of those companies cannot be said to be, in and of itself, sufficient to safeguard the independence of such committees. The fact that members of the company's audit committee are directors of that company cannot justify any lesser amount of attention given to the manner in which such members of audit committee are appointed.

It must be noted that members of the company's audit committee are generally not appointed by the company's board of directors,[552] except pursuant to the provisions of section 94(3)*(b)* or section 94(6) of the Companies Act 2008. However, as it will be demonstrated in Chapter 5 of this thesis, it makes no difference, in some instances, whether members of the audit committee are appointed by the company's board of directors or its shareholders. What is of critical importance is that the divergence as to whether the company's audit committee is accountable to the company's board of directors or the shareholders in a meeting, and whether the

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[551] This is not to ignore the well-established corporate law principle that directors of the company (as members of the company's audit committee are, or required to be) owe their fiduciary duty to the company and not to the individuals who appointed or nominated them for appointment.

[552] Delport P *Henochsberg's Commentary on the Companies Act 71 of 2008* (2017) 357.

audit committee is the committee of the board or a standalone organ of the company is resolved. The independence of the audit committee and protection thereof rest, to a greater degree, on a proper characterisation of the committee's place in the corporate structure and to whom it accounts, taking into account the legislative intention and purpose of the provisions of the Companies Act 2008 governing the appointment and duties of the audit committee.

For start-up companies, the first members of the audit committee may be appointed by the company's incorporators[553] or by the board, within 40 days after the incorporation of the company.[554] It is not clear from the reading of section 94(3)*(b)* of Companies Act 2008 if the board of directors would be in breach of its duties if it fails to appoint members of the audit committee as prescribed by that section. As the section appears to be non-peremptory, it is submitted that the board is not obliged to make such appointments. The board of directors is also empowered to appoint a person who satisfies the requirements of section 94(4)*(a)* to fill a vacancy on the company's audit committee, within 40 days after such vacancy has occurred.[555] It is, however conceivable, that where a public company (except for a public entity) or any other company[556] whose MOI requires that company to appoint the audit committee, has only the requisite minimum number of directors comprising of only non-executive directors, all such non-executive directors may be appointed into the audit committee either by the incorporators or the board, at least until the company's first annual general meeting. This may present a situation where all members of the company's board of directors, including its chairperson,[557] serve as

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[553] S 94(3)(a) of the Companies Act 2008.

[554] S 94(3)(b) of the Companies Act 2008.

[555] S 94(6) of the Companies Act 2008.

[556] A private or personal liability company may have only one director. However, if such company's MOI prescribes that the company appoints an audit committee, then that company must have a minimum of three directors; See Delport P *Henochsberg's Commentary on the Companies Act 71 of 2008* (2017) 357.

[557] Recommended Practice 36.a under Principle 7 of Part 5.3 of the *King IV Code* recommends that the chairperson of the board of the company should not be a member of the company's audit committee. However, the *King IV Code* is a voluntary code which employs the principle of 'apply and explain'. In this context, it is summited that a chairperson of the board may only not be a member of the company's audit committee, if the company can explain as to how such move would be in the best interest of the company. The reason for this is that the company cannot employ what is referred to 'tick-box' approach, by applying recommended practice 36.a only for compliance purposes, while it cannot be explained as to how such move is beneficial to the company. The position is the same under the PFMA, as the Treasury Regulation 27.1.3 only prescribes that the chairperson of the audit committee the public entity *may not* a member of that entity's accounting authority.

the only members of the company's audit committee in a particular point in time. In such instances, the difficulty may arise where members of the audit committee, individually and/or collectively, fail to separate their duties and responsibilities as members of the audit committee and their duties and responsibilities in their capacity as members of the board of directors. This is in light of the controversial idea that the audit committee is an independent standalone organ of the company. For this reason, it is submitted that the decisions of the audit committee must be clear and separate from the decisions of the board. For example, the decisions in respect of nomination of the auditor, determination of audit fees and the auditor's terms of reference can only be the decisions of the audit committee as contemplated in section 94(10) of the Companies Act 2008.

At its first and every other subsequent annual general meeting, the company must elect members to serve on its audit committee,[558] except where the provisions of section 94(2)*(a)* and *(b)* apply. To be clear, this is the annual general meeting of the company's shareholders and not that of the company's board of directors,[559] as there is no separate annual general meeting for the board of directors only. Nevertheless, where all shareholders of the company also serve as and sit on the company's board of directors, it is submitted that the statutory requirement to elect members of the audit committee at the company's annual general meeting of shareholders would become a mere academic exercise (own deduction). The reason for this is that the legislative intention of section 94(2), read with subsection (4), of the Companies Act 2008 is presumably to safeguard the independence of the company's audit committee. It therefore would make no difference that shareholders, where all of whom are members of the company's board of directors, would cast a vote, at the annual general meeting, which they would, in any case, have cast at the meeting of the company's board of directors. The foregoing presents circumstances where the independence of the company's audit committee may be deeply eroded. It would mean that members of the audit committee would be appointed by the board of directors, as opposed to the shareholders as contemplated in section 94(2) of the Companies Act 2008.

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[558] S 94(2) of the Companies Act 2008.

[559] Delport P *Henochsberg on the Companies Act 71 of 2008* (2017) 357.

As a matter of leading practice, the *King IV Code* recommends that companies which issue audited financial statements should establish audit committees.[560] It further recommends that such audit committees should be appointed by the companies' boards of directors.[561] Remarkably, the Companies Act 2008 does not make any provision for how the chairperson of the company's audit committee is to be appointed. However, the *King IV Code* recommends that an independent, non-executive director should be appointed by the company's board of directors, to chair the audit committee.[562] It will be canvassed in Chapter 5 of this study that the power conferred on the company's board of directors, to appoint any member of the company's audit committee, let alone a chairperson of such committee, is highly problematic.

3.2.3 Appointment of members of the audit committee under the PFMA

The provisions of the Companies Act 2008 and the *King IV Code* dealing with the appointment of members of the audit committee also apply to public entities, unless exempted.[563] It must also be underscored that the provisions of the Companies Act 2008 must be applied concurrently with the provisions of the PFMA,[564] and where there are irreconcilable inconsistences, the provisions of the PFMA prevail.[565] Further, the *King IV Code* recognises that the composition of the audit committee of a public entity, and by necessary implication, the appointment of its members, is prescribed by legislation which prevails over the *King IV Code*.[566] However, where there is no inconsistency between the voluntary *King IV Code* and the PFMA, the conduct of the public entities is expected to be measured against the relevant principles of the *King IV Code* and must adhere to recommended best practices.[567]

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[560] Recommended Practice 51 under Principle 8 of Part 5.3 of the *King IV Code.*
[561] Recommended Practice 51 under Principle 8 of Part 5.3 of the *King IV Code.*
[562] Recommended Practice 57 under Principle 8 of Part 5.3 of the *King IV Code.*
[563] In terms of section 9(2) of the Companies Act 2008, the Minister responsible for companies to grant a total, partial or conditional exemption from one or more provisions of this Act, applicable to all state-owned companies, any class of state-owned companies, or to one or more particular state-owned company.
[564] S 5(4)(a) of the Companies Act 2008.
[565] S 5(4)(b)(i)(ee) of the Companies Act 2008.
[566] See the explanatory note appearing under Principle 8 of Part 6.6 of the *King IV Code.*
[567] *South African Broadcasting Corporation v Mpofu* (A5021/08) [2009] ZAGPJHC 25; [2009] 4 All SA 169 (GSJ) (11 June 2009) para 29.

Under the PFMA, the audit committee of the public entity is appointed by the entity's accounting authority.[568] Unlike the Companies Act 2008 which gives the company's shareholders the power to elect and appoint members of the audit committee at the company's annual general meeting, the PFMA does not give the executive authority of the public entity any powers to appoint or be involved in the appointment of members of the entity's audit committee. The reason for this may be the fact that the PFMA envisions the audit committee as the subcommittee of the entity's accounting authority.[569] On this basis, it follows, therefore, that the audit committee of the public entity is accountable to the entity's accounting authority. This gives the accounting authority enormous powers to not only pick and choose the individuals who may serve as members of the entity's audit committee but also to possibly dictate how members may execute their mandate, to secure their tenure[570] or reappointment.

The question is whether members of the audit committee of the public entity may be appointed in terms of the provisions of the Companies Act 2008? A sub-question could be posed as follows: Can the executive authority of a public entity, being the government shareholder representative, invoke provisions of section 94(2) of the Companies Act 2008 to annually appoint members of the entity's audit committee, despite the fact that the PFMA confers such power to only the entity's accounting authority? With the South African public entities having proven to be highly politicised in the past decade or so, with allegations of political interference in the management of these entities, any attempt by the government shareholder representatives to be involved in the appointment of the entities' audit committees may be construed to mean another attempt by political heads to control these public entities.

In its guidance paper titled *'The Relationship between Audit Committees and Governing Bodies'*, the Public Sector Audit Committee Forum[571] ('PSACF')

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[568] Regulation 27.1.1 of the Treasury Regulation for PFMA.

[569] Regulation 27.1.1 of the Treasury Regulation for PFMA.

[570] This tenure must be understood in the context of security of membership to the company's audit committee until the end of term of appointment.

[571] The Public Sector Audit Committee Forum is a body founded in 2011 by the Institute of Directors in Southern Africa (IoDSA), The Institute for Internal Auditors in South Africa (IIASA), the South African Institute of Chartered Accountants (SAICA), The Institute of Risk Management South Africa (IRMSA), National Treasury (NT), the Auditor-General South Africa (AGSA) and

recognises the audit committee as a key contributor to good governance in public entities and that it plays a crucial role in assisting the relevant governing bodies in discharging their responsibilities in overseeing financial and performance management, compliance with legal and other regulatory requirements and internal controls.[572] In highlighting the challenges which affect the interaction between the audit committees and governing bodies of public entities, the PSACF points out that the executive authority of the public entity is often involved in the appointment of the entity's audit committee.[573] However, this does not only create reporting line uncertainly but may also impair the committee's independence due to previous or current relationships of audit committee members or the audit committee as a whole and political standing.[574]

3.2.4 Removal or suspension members of the audit committee

This segment of the study deals with the removal of members of the company's audit committee. The removal may be permanent or temporary through suspension. This must not be confused with the removal or suspension of a director from his or her position of directorship. This discussion is based on the hypothesis that a director may be relieved off his or her duties as a member of the audit committee, without necessarily removing that director from his or her directorial position or as member of the company's board of directors. There are a number of circumstances which may trigger this removal. For example, a member of the audit committee may, for a sound strategic purpose, be removed prematurely from the audit committee and be reappointed to another committee. Another example may be where a member of the audit committee is removed by the company's governing body from that audit committee for improper purpose.

Development Bank of Southern Africa (DBSA) in a joint effort to facilitate guidance of and assistance to members of public sector audit committees. The Guidance papers are available at https://www.psacf.co.za/page/GuidancePapers (accessed on 10 July 2020).

[572] Public Sector Audit Committee Forum 'The Relationship between Audit Committees and Governing Bodies' 3, available at https://www.psacf.co.za/page/GuidancePapers (accessed on 10 July 2020).

[573] Public Sector Audit Committee Forum 'The Relationship between Audit Committees and Governing Bodies' 5, available at https://www.psacf.co.za/page/GuidancePapers (accessed on 10 July 2020).

[574] Public Sector Audit Committee Forum 'The Relationship between Audit Committees and Governing Bodies' 5, available at https://www.psacf.co.za/page/GuidancePapers (accessed on 10 July 2020).

3.2.4.1 Removal of members of the audit committee by the governing body

It must be reiterated that members of the company's audit committee are not employees of the company.[575] They must be independent non-executive directors,[576] whose only relationship with the company is through their independent directorship. It follows, therefore, that the Labour Relations Act 66 of 1995 ('LRA') does not apply to the relationship between members of the audit committee and the company. The LRA must be considered when terminating the employment contracts between the company and its executive directors.[577]

It is bothersome that the Companies Act 2008 does not make any provision for the removal of members of the audit committee from the committee. Consequently, it is not clear whether the powers to remove members of the committee are vested in the board of directors or the shareholders. What is not doubtful though is that, by virtue of provisions of section 94(4)*(a)* of the Companies Act 2008, a member of the audit committee ceases to be such a member when he or she voluntarily resigns or is removed as a director of the company or is placed under probation or is declared delinquent in terms of the Companies Act 2008.[578] Thus, the only ambiguity is whether the board of the company has the powers to create a vacancy on the audit committee, just as it has the powers to fill any such vacancy in terms of section 94(6) of the Companies Act 2008. This question becomes particularly important where members of the audit committee were appointed by the company's shareholders at the annual general meeting as contemplated in section 94(2). To be more direct, the question is whether the company's board has the powers to prematurely remove members of the audit committee who were appointed to the committee by the

[575] S 94(4)(b) of the Companies Act 2008.

[576] Recommended Practice 56 under Principle 8 of Part 5.3 of the *King IV Code.*

[577] See Cassim et al *Contemporary Company Law* 3 ed (2021) 613-615.

[578] For example, section 71(3) of the Companies Act 2008 empowers the board of directors to remove a fellow director. In terms of section 162(2), a company or one of the persons listed in that subsection, may apply to court for an order placing a director under probation or declaring a director delinquent. Section 69(5) provides that a director who has been placed under probation cannot serve as a director except to an extent permitted by the probation order. Section 69(8)(a) disqualifies a person who has been declared a delinquent director to be appointed as a director of the company. Section 94(4)(a) prescribes that each member of the company's audit committee must be a director of that company.

company's shareholders and replace those members with members of its (the board's) choice?

As already mentioned, the Companies Act 2008 gives the board of directors the powers to establish the audit committee and appoint first members to that committee.[579] The board also has the power to appoint a member to fill a vacancy on the company's audit committee.[580] It is submitted, therefore, that it may not imaginably be the intention of legislature to give the board the powers to appoint members of the audit committee but deny it the analogous powers to remove or dismiss such members from the committee. The power to appoint presupposes the right and/or power to remove or dismiss.[581] In *Masetlha v President of the Republic of South Africa and Another*,[582] the Constitutional Court per Moseneke DCJ, as he then was, stated this position thus:

> Without the competence to dismiss, the President would not be able to remove the head of the Agency without his or her consent before the end of the term of office, whatever the circumstances might be. That would indeed lead to an absurdity and severely undermine the constitutional pursuit of the security of this country and its people. That is why the power to dismiss is an essential corollary of the power to appoint and the power to dismiss must be read into section 209(2) of the Constitution. There is no doubt that the power to appoint under section 209(2) of the Constitution and the power under ISA implies a power to dismiss.[583]

The dictum in the *Masetlha* case was cited in a number of subsequent judgments, notably in *MEC: Free State Provincial Government: Tourism, Economic and Environmental Affairs v Moeko and Others*[584] and more recently in *South African Broadcasting Corporation (Soc) Ltd v Keevy and Others*.[585] Consequently, it is submitted that the company's board of directors has the analogous powers to remove members from the audit committee from that committee.

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[579] S 94(3)(b) of the Companies Act 2008.
[580] S 94(6) of the Companies Act 2008.
[581] *Masetlha v President of the Republic of South Africa and Another* 2008 (1) SA 566 (CC) para 68, where it is stated the power to remove or dismiss is necessary in order to exercise the power to appoint.
[582] 2008 (1) SA 566 (CC).
[583] *Masetlha v President of the Republic of South Africa and Another* para 68.
[584] (JR 2582/07) [2013] ZALCJHB 15; (2013) 34 ILJ 2256 (LC) (8 February 2013) para 35.
[585] (J1652-19) [2020] ZALCJHB 31 (7 February 2020) para 49.

The powers of the board of directors to remove or dismiss members of the audit committee is implicitly located within the provisions of section 94(3)*(b)* and 94(6) of the Companies Act 2008. To borrow from the language and tone of Moseneke DCJ, it would be an absurdity and severely undermine the legislative and indeed constitutional pursuit of good corporate governance and accountability in South African companies, if those who are empowered to appoint are not conferred with the corollary powers to dismiss those who they have appointed. However, it will be demonstrated in Chapter 5, that the powers conferred on the company's board of directors, to appoint and analogously to remove members of the company's audit committee pose a serious threat on the independence of the audit committee.

Similarly, the accounting authority of a public entity may appoint members of the entity's audit committee in terms of Regulation 27.1.1 of the Treasury Regulations for PFMA. This Regulation does not specifically use the term 'appoint' but it is expected that the process of establishing the entity's audit committee includes the appointment of members who would constitute and serve on such committee. As propounded above, for its power to appoint, the accounting authority has the corollary powers to remove members of the entity's audit committee. However, if the accounting authority of the public entity decides to prematurely remove a member of the entity's audit committee, the relevant executive authority of that entity must approve of such removal.[586] The Companies Act 2008 does not have a similar provision. This means that if the company's board of directors decides to remove a member of the audit committee before end of term of office, the company's shareholders do not play any part in the process of that removal.

3.2.4.2 Removal of members of the audit committee by the shareholders

It is suggested that, as there is no express provision for the removal of members of the company's audit committee, such arrangement may be determined by the company's MOI.[587] By this, it means that the company's MOI may make provisions for substantive grounds and procedural steps which must be taken into account when removing members of the audit committee from such committee before end

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[586] Regulation 27.1.5 of the Treasury Regulation for PFMA.

[587] Ncube CB 'Transparency and accountability under the new company law' (2010) *Acta Juridica* 72.

of the term of office. In the absence of such provisions in the company's MOI, it is not clear whether the shareholders may exercise their powers under the Companies Act 2008 to remove a member of the company's audit committee through shareholders' ordinary resolution.

A member of the company's audit committee may be removed as a director of that company by an ordinary resolution of the company's shareholders,[588] upon which the director so removed ceases to be a member of that company's audit committee.[589] However, it must be noted that the shareholders are only empowered to remove directors whom they, the shareholders, have powers to appoint.[590] For example, the shareholders cannot remove an *ex-officio* director or a director directly appointed by the company's board of directors and will have to rely on the board or the Companies Tribunal to effect the removal.[591] It follows, therefore, that the shareholders of the company have the powers to remove directors who are serving on the company's audit committee, provided such members were appointed as directors by the shareholders. In such cases, it does not matter whether the member was appointed to the company's audit committee by the shareholders in terms of section 94(2) or by the board of directors as contemplated in section 94(3)*(b)* or 94(6) of the Companies Act 2008.

However, a situation may arise where the shareholders of the company may contemplate the removal of a member of the audit committee from such committee without removing such a member as a director of the company. For example, a director who was appointed by the company's board of directors in terms of the company's MOI,[592] to serve as a director of the company, may later be appointed by the shareholders at the company's annual general meeting, to serve on the company's audit committee. In this scenario, it is controversial whether the shareholders would have the powers to remove such a member of the audit committee from the position of directorship,[593] for the purpose of removing such

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[588] S 71(1) of the Companies Act 2008.

[589] In terms of section 94(4)(a) of the Companies Act 2008, only directors of the company may serve on that company's audit committee.

[590] S 71(1) of the Companies Act 2008.

[591] Ncube CB 'You're fired! The removal of directors under the Companies Act 2008 71 of 2008' (2011) 128 *SALJ* 39.

[592] See section 66(4)(a)(i) of the Companies Act 2008.

[593] In terms of section 71(1) of the Companies Act 2008, the shareholders are only empowered to

director from the audit committee. However, as propounded above, the power to remove or dismiss is necessary in order to exercise the power to appoint.[594] Thus, it is submitted that the shareholders could still invoke their analogous powers to remove members of the audit committee as implied in sections 94(2) and 61(8)(c)*(ii)* even if they, the shareholders, may not have powers to remove such directors from their position of directorship.

The provisions of sections 94(2) and 61(8)(c)*(ii)* of the Companies Act 2008 deal with shareholders of the company acting at the company's annual general meetings. Although, both meetings are the meetings of the company's shareholders, the Companies Act 2008 makes a clear distinction between a 'shareholders' meeting' and an 'annual general meeting'.[595] While a shareholders' meeting may be called *any time* by the company's board of directors or any person designated in the company's MOI,[596] an annual general meeting must be convened *once in every calendar year*.[597] Unlike a shareholders' meeting, an annual general meeting is required to, at a minimum, transact the business of, *inter alia*, appointing the company's audit committee.[598] This appointment of audit committee is undertaken pursuant to the provisions of section 94(2), which make provision for the business of electing (and by necessary implication, appointing - emphasis added) members of the company's audit committee to be undertaken at the company's annual general meeting. From the foregoing, it appears as though that the shareholders' meeting may not be called *any time* for shareholders to consider the appointment or analogously, the removal of members of the company's audit committee. Such business appears to be reserved for the company's annual general meeting.

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pass an ordinary resolution for removal of directors whom they, the shareholders, are entitled to exercise voting rights in their appointment; Also see Ncube CB 'You're fired! The removal of directors under the Companies Act 2008 71 of 2008' (2011) 128 *SALJ* 39. However, Cassim et al *Contemporary Company Law* 3 ed (2021) at 597-599 advances a persuasive argument that the provisions of section 71(1) may be interpreted to mean that a director appointed by the board of directors pursuant to the provisions of the company's MOI may still be removed by the shareholders, 'despite anything to the contrary in the company's MOI'.

[594] *Masetlha v President of the Republic of South Africa and Another* 2008 (1) SA 566 (CC) para 68.

[595] Cassim et al *Contemporary Company Law* 3 ed (2021) at 491.

[596] S 61(1) of the Companies Act 2008.

[597] S 61(7)(b) of the Companies Act 2008. Also see Cassim et al *Contemporary Company Law* 3 ed (2021) 491.

[598] S 61(8)(c)(ii) of the Companies Act 2008.

Under the PFMA, the executive authority of the public entity under the ownership control of the national or a provincial executive must exercise that executive's ownership control powers to ensure that that public entity complies with the PFMA and the financial policies of that executive.[599] The phrase 'ownership control' is defined in the PFMA as the ability to exercise the powers to, *inter alia*, appoint or remove all, or the majority of, the members of that entity's board of directors or equivalent governing body, so as to govern the financial and operating policies of the entity in order to obtain benefits from the entity's activities.[600] From this, an inference may be drawn that a member of the public entity's audit committee, who is also a member of that entity's accounting authority, may be removed by the entity's executive authority from the entity's audit committee by removing that member from the entity's accounting authority.

It must, however, be noted that not all members of the public entity's audit committee need to be members of that entity's accounting authority.[601] Therefore, where a member of the public entity's audit committee is not a member of the entity's accounting authority, such member may not be removed from the entity's audit committee by the entity's executive authority. Such power may only be exercised by the entity's accounting authority as implied in the Regulation 27.1.1 of Treasury Regulation for PFMA.[602] The executive authority of the public entity is not involved in the removal of the member of entity's audit committee, except to concur with that removal.[603] Disappointingly, the PFMA is silent on what should happen where the accounting authority and the executive authority of the public entity are in disagreement about the premature termination of the service of a member of the entity's audit committee.

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[599] S 63(2) of the Public Finance Management Act 1 of 1999.
[600] S 1 of the Public Finance Management Act 1 of 1999.
[601] Regulation 27.1.4 of the Treasury Regulation for PFMA.
[602] As already discussed with authority of *Masetlha,* the power to remove or dismiss is necessary in order to exercise the power to appoint.
[603] Regulation 27.1.5 of the Treasury Regulation for PFMA.

3.3 THE ROLE, FUNCTIONS, DUTIES OF THE AUDIT COMMITTEE AND EFFECT ON INDEPENDENCE

3.3.1 The functions and statutory duties of the audit committee

3.3.1.1 Functions and duties under the Companies Act 2008

The statutory duties of the audit committee are codified in section 94(7) of the Companies Act 2008. The list of duties under the Companies Act 2008 encapsulates all functions of the audit committee set out in section 270A(1) of the Companies Act 1973, with minor modifications. Additionally, the *King IV Report* makes recommendations of a number of functions and duties which should be adopted by companies' audit committees.

From the reading of the duties as contemplated in section 94(7), it appears that the statutory duties of the company's audit committee may not be altered by any provision in the company's constitutive documents. In other words, these duties may not be negated, restricted, limited, qualified, extended or otherwise altered in substance or effect by the company's MOI or any resolution of the board of directors or shareholders.[604] It is submitted that they are peremptory duties which must be discharged by the audit committee, whether the committee was established voluntarily or as per the dictates of the Companies Act 2008 or the PFMA, in the case of public entities.

3.3.1.1.1 Nomination of a registered auditor for appointment

The audit committee is responsible for, among other things, nomination of an independent registered auditor to be appointed by the company in terms of the Companies Act 2008[605]. It must be pointed out that the audit committee of the company does not appoint the company's auditor but rather only nominates an independent registered auditor, who may be appointed at an annual general meeting of shareholders. The purpose of the audit committee's nomination of the

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[604] See s 1 of the Companies Act 2008, which state that alterable provisions are provision of that Act in which it is expressly stated that its effect on a particular company may be negated, restricted, limited, qualified, extended or otherwise altered in substance or effect by that company's MOI.
[605] S 94(7)(a) of the Companies Act 2008.

company's auditor is ostensibly to measure the independence of that auditor in terms of the criteria set out in section 94(8) of the Companies Act 2008. Further, the audit committee is required to provide an express statement whether it is satisfied that the registered auditor is independent of the company.[606] This is aimed at assisting the shareholders in deciding whether to appoint a particular registered auditor.

The first auditor of the company is appointed by the company's incorporators at the time of incorporation of the company and subsequently, at the company's annual general meetings.[607] While the audit committee is required to nominate an independent registered auditor for appointment, the Companies Act 2008 empowers the shareholders to appoint an independent registered auditor other than that which was nominated by the company's audit committee.[608] In such cases, the audit committee must, however, be satisfied that the auditor, so appointed, is independent.[609] Seemingly, the provisions of section 94(9) of the Companies Act 2008 ensure that the powers to appoint the company's auditor are firmly ingrained in the shareholders of the company, so as to enhance the independence of the auditor. The provisions of the Companies Act 2008 regulating the determination of whether an auditor is independent, fall outside the scope of this study and will therefore not be discussed, save to mention that the audit committee must apply such provisions in the assessment of the independence of the company's auditor.

Although, the role of the company's audit committee in the appointment of the auditor is only limited to the assessment of independence and nomination of the auditor and not the actual appointment, the audit committee must ensure that the appointment of the auditor complies with the relevant provisions of the Companies Act 2008 and any other legislation relating to the appointment of auditors.[610] For example, the audit committee must ensure that the appointment of the company's auditor complies with the provisions of section 90(2) of the Companies Act 2008, in

[606] Recommended Practice 59.a under Principle 8 of Part 5.3 of the *King IV Code.*
[607] S 90(1) of the Companies Act 2008.
[608] S 94(9) of the Companies Act 2008.
[609] S 94(9) of the Companies Act 2008.
[610] S 94(7)(c) of the Companies Act 2008.

so far as the auditor is a registered auditor[611] and that the auditor is not prohibited from appointment as contemplated in section 90(2)*(b)* of that Act.

3.3.1.1.2 Audit fees and the auditors' terms of engagement

The duties of the company's audit committee include determination of fees to be paid to the company's registered auditor and the terms of the auditor's engagement.[612] Despite the fact that the business and affairs of the company are managed by or under the stewardship of the company's board of directors, the duty to determine audit fees and the scope of the audit engagement is the sole responsibility of the company's audit committee.[613] This inference may be drawn from the provision of section 94(10) of the Companies Act 2008, which states that neither the appointment nor the duties of an audit committee reduce the functions and duties of the board or the directors of the company, except with respect to the appointment, fees and terms of engagement of the company's auditor. From the foregoing, it would appear that the board of directors does not have the powers to interfere with the duty of the company's audit committee in the determination of the terms of the audit work to be undertaken by the company's auditor and the fees to be paid therefor.

With regards to the appointment of the company's auditor, the board of directors is empowered to appoint the auditor pursuant to section 91(2) of the Companies Act 2008. The appointment under this section is only possible to fill the vacancy in the office of the company's auditor.[614] Interestingly, the audit committee need not nominate an independent auditor to be appointed by the board of directors. Instead, the board is required to propose to the audit committee the name of the auditor whom the board intends to appoint,[615] and proceed to appoint such proposed auditor, unless the audit committee expressly objects to the appointment of such auditor within the prescribed period.[616] Therefore, despite the provisions of section 94 of the Companies Act 2008 with respect to the appointment of the auditor, the

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[611] S 90(2)(a) of the Companies Act 2008.
[612] S 94(7)(b) of the Companies Act 2008.
[613] S 94(7)(b), read with subsection (10) of the Companies Act 2008.
[614] S 91(2) of the Companies Act 2008.
[615] S 91(3)(a) of the Companies Act 2008.
[616] S 91(3)(b) of the Companies Act 2008.

board of directors may interfere with the appointment of the company's independent registered auditor to fill a vacancy.

3.3.1.1.3 Determining the nature, extent and pre-approval of non-audit services that the auditor may provide to the company

The Companies Act 2008 envisages that the auditor's engagement with the company may not necessarily be limited to the provision of audit services. In this regard, the Companies Act 2008 imposes the duty on the company's audit committee to determine the nature and extent of any non-audit services that the auditor may provide to the company or its related company,[617] and to pre-approve an agreement with the auditor for the provision of any such non-audit services.[618] Similarly, the audit committee may determine which non-audit work the auditor may not carry out for the company or its related company.[619] The reason for this is that the auditor is not allowed to perform any services, including non-audit work, that would place the auditor in a position of conflict of interests[620] or any services as may be determined by the audit committee.[621]

To illustrate this point, some studies suggest that there is no link between non-audit fees and auditor independence, and that the auditor's concern with maintaining its reputation for providing high-quality audits could restrain it from undertaking activities that could threaten its independence.[622] However, other studies suggest that the provision of non-audit services compromises the auditor independence.[623] On this basis, it is submitted that the need for a proper assessment of the auditors' provision of non-audit services *vis-a-vis* the performance of statutory audit services cannot be downplayed. Further, a registered auditor is prohibited from conducting any audit work in the company if such auditor has conflict of interests.[624] Such

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[617] S 94(7)(d) of the Companies Act 2008.
[618] S 94(7)(e) of the Companies Act 2008.
[619] S 94(7)(d) of the Companies Act 2008.
[620] S 93(3)(a) of the Companies Act 2008.
[621] S 93(3)(b) of the Companies Act 2008.
[622] Zhang Y, Zhou J & Zhou N 'Audit committee quality, auditor independence, and internal control weaknesses' (2007) 26 *Journal of Accounting and Public Policy* 306-307.
[623] Zhang Y, Zhou J & Zhou N 'Audit committee quality, auditor independence, and internal control weaknesses' (2007) 26 *Journal of Accounting and Public Policy* 306-307.
[624] S 44(6) of the Auditing Profession Act 26 of 2005.

conflict may arise from the auditor's provision of audit services in circumstance where that same auditor had previously provided non-audit services.

3.3.1.1.4 Audit committee reporting (preparing a report for inclusion in financial statements)

The audit committee must prepare a report which must be included in the company's annual financial statements for each financial year.[625] The report must include express statements as to how the audit committee carried out its functions;[626] whether the audit committee is satisfied with the independence of the auditor from the company;[627] and any other comments regarding the company's financial statements, the accounting practices and the internal financial controls.[628] The audit committee is required to present its audit committee report at the annual general meeting of the company's shareholders.[629]

In disclosing in its annual reporting whether it is satisfied that the auditor is independent from the company, it is recommended that the audit committee should also specifically state the policies and controls which address the provision of non-audit services by the auditor.[630] Importantly, the audit committee report should expressly address the rotation of the designated audit partner[631] and the audit committee's view on the effectiveness of the Chief Audit Executive ('CAE') and the arrangement of the internal audit function.[632] The rotation of the company's registered auditor and audit partner is prescribed in terms of section 92 of the Companies Act 2008.

3.3.1.1.5 Handling of complaints and submissions to the board of directors

The Companies Act 2008 appears to give the audit committee very broad, yet ambiguous powers and responsibilities in terms of sections 94(7)*(g)* and *(h)* of that

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[625] S 94(7)(f) of the Companies Act 2008.
[626] S 94(7)(f)(i) of the Companies Act 2008.
[627] S 94(7)(f)(ii) of the Companies Act 2008. Also see Recommended Practice 59.a under Principle 8 of Part 5.3 of the *King IV Code.*
[628] S 94(7)(f)(iii) of the Companies Act 2008.
[629] S 61(8)(iii) of the Companies Act 2008.
[630] Recommended Practice 59.a.i under Principle 8 of Part 5.3 of the *King IV Code.*
[631] Recommended Practice 59.a.iii under Principle 8 of Part 5.3 of the *King IV Code.*
[632] Recommended Practice 59.d under Principle 8 of Part 5.3 of the *King IV Code.*

Act. In particular, subsection (7)*(g)* empowers the company's audit committee to deal appropriately with any concerns and/or complaints relating to the company's accounting practices and auditing of financial statements and the company's internal financial controls.

The phrase 'deal appropriately with' in section 94(7)*(g)* may be problematic in so far as it does not unequivocally define what it means and to what extent or level of appropriateness the audit committee is empowered to deal with the matters referred to in that subsection. It may be difficult to establish a reasonably suitable and universally acceptable test to determine, objectively, whether the audit committee would have appropriately dealt with the matter referred to it. In some instances, the audit committee, whose members may also serve on the company's board of directors, may be confronted with matters which implicate some or the entire board of directors. The foregoing may create corporate governance dilemma in so far as the audit committee would be expected to deal appropriately with matters in which all or some of its members are implicated. The difficulty may be heightened by the fact that, though the implicated members of the committee may recuse themselves from the deliberations of matters on which they are implicated, the Companies Act 2008 is silent on whether the board of directors or the shareholders have the powers to appoint temporary replacement members of the audit committee.

The Companies Act 2008 prescribes that the audit committee must be constituted with a minimum of three members. Further, the Companies Act 2008 only makes provisions for appointment of members of the audit committee by shareholders[633] or board of directors.[634] It is submitted that, where a member of the audit committee temporarily recuses him or herself on the basis of conflict of interests, no vacancy on the audit committee is given rise to by such recusal and therefore, section 94(6) of the Companies Act 2008 will not apply. This may leave the audit committee in a state of paralysis or conflict of interests on its endeavours to deal appropriately with certain critical matters.

[633] In terms of s 94(2) of the Companies Act 2008.
[634] See ss 94(3) and 94(6) of the Companies Act 2008.

As regards the making of submissions to the board on any matter concerning the company's accounting policies, financial controls, records and reporting in terms of sections 94(7)*(h)* of the Companies Act 2008, this duty appears to be open-ended, and may leave both the audit committee and the board of directors second-guessing what it might entail. However, it is submitted that this duty may be elucidated in the audit committee charter or terms of reference.

3.3.1.1.6 Other oversight functions

The Companies Act 2008 makes provision for the board of directors to determine and assign some oversight responsibilities to the company's audit committee.[635] The Companies Act 2008 does not provide an express statement of which oversight functions the board may delegate to the audit committee. It would appear that such a determination may be governed by the company's MOI or the board's resolution.

It is not clear whether the legislative intention of section 94(7)*(i)* of the Companies Act 2008 is to create a delegation of authority mechanism with which the board of directors may determine and delegate some oversight functions to the company's audit committee. Alternatively, the intention could be that once such oversight functions have been determined and assigned to the audit committee, they become statutory responsibilities of the audit committee. Nevertheless, the distinction is less important because in the former case, the delegation does not discharge the board of directors from its fiduciary and statutory duties[636] and in the latter case, the audit committee and its duties do not reduce the functions and duties of the board or the directors of the company, except with respect to the appointment, fees and terms of engagement of the auditor.[637] As propounded in the next chapter, the provisions of section 94(10) of the Companies Act 2008 give the company's board of directors some stimulus to interfere with the independence of the company's audit committee.

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[635] S 94(7)(i) of the Companies Act 2008.
[636] Recommended Practice 49 under Principle 8 of Part 5.3 of the *King IV Code*. Also see Cassim et al *Contemporary Company Law* 3 ed (2021) 756.
[637] S 94(10) of the Companies Act 2008.

3.3.1.2 Functions and duties under the Public Finance Management Act

The audit committee of a public entity must operate in terms of written terms of reference, which must deal with, *inter alia*, the committee's responsibilities, which must be reviewed at least annually to ensure its relevance.[638] However, the Treasury Regulations for PFMA itemise a number of statutory duties of the audit committee of a public entity under the PFMA.[639] This includes the committee's duty to review, among others, the independence and objectivity of the external auditors[640] and report and make recommendations to the public entity's accounting authority.[641]

It must be stated that the PFMA does not make provision for the involvement of the audit committee in the appointment of an independent registered auditor of the public entity. The reason for this may be that the external audit functions of the public entities are regulated in terms of the Public Audit Act.[642] The *King IV Report* notes that the duties of the audit committee in relation to the appointment and independence of the external auditor apply differently to the public entities as the Auditor-General generally serves as the external auditor of the public entities.[643] In terms of the Public Audit Act, the Auditor-General may exercise its constitutional duty by performing audits and reporting on the accounts, financial statements and financial management of any public entity listed in the PFMA.[644] If the Auditor-General decides not to perform audit functions of the public entity for a particular financial year, the entity must appoint a duly registered auditor,[645] subject to the Auditor-General not rejecting the appointment of such auditor.[646] However, it is not clear whether the appointment of an auditor as contemplated in section 25(1)*(b)* of the Public Audit Act must be done by or in consultation with the entity's audit committee and/or the executive authority.

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[638] Regulation 27.1.6 of the Treasury Regulation for PFMA.
[639] Regulation 27.1.8 of the Treasury Regulation for PFMA.
[640] Regulation 27.1.8(h) of the Treasury Regulation for PFMA.
[641] Regulation 27.1.10(a) of the Treasury Regulation for PFMA.
[642] Act No. 25 of 2004.
[643] *King IV Report* (2016) 115.
[644] S 4(3)(a) of the Public Audit Act 25 of 2004.
[645] S 25(1)(b) of the Public Audit Act 25 of 2004.
[646] S 25(3) of the Public Audit Act 25 of 2004.

The PFMA does not make any provision for the audit committee of the public entity to play any supervisory or oversight role on the function of the entity's external audit function. In relation to external audits, the audit committee is only required to review the public entity's risk areas which must be covered in the auditor's audit scope,[647] any accounting and auditing concerns identified as a result of external audits[648] and the independence and objectivity of the external auditors, where applicable.[649] The audit committee of the public entity is further required to review the activities of the internal audit function, coordination with the external auditors and the reports of significant investigations and the responses of management to specific recommendations.[650] Principle 8 of Part 5.3 of the *King IV Code* makes recommendations for practices in respect of the objective oversight by the audit committee over all assurance service providers and functions, as well as the quality of their output. It must be highlighted that the provisions of Principle 8 of Part 5.3 of the *King IV Code* also apply to the public entities,[651] subject to the provisions of the Companies Act 2008, the Public Finance Management Act, the Public Audit Act and Auditing Profession Act.

3.3.2 Other functions and duties of the audit committee

3.3.2.1 Oversight of the audit functions

There is a consensus among corporate governance experts that the role of the audit committee and its level in the company is that of an independent oversight body.[652] The audit committee's oversight role over the company's audit functions should ensure that the audit work is carried out independently and that the audit findings

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[647] Regulation 27.1.8(c) of the Treasury Regulation for PFMA.
[648] Regulation 27.1.8(e) of the Treasury Regulation for PFMA.
[649] Regulation 27.1.8(h) of the Treasury Regulation for PFMA.
[650] Regulation 27.1.8(g) of the Treasury Regulation for PFMA.
[651] *King IV Report* (2016) 115.
[652] Marx B (2008) 84; Al-Mahamid SM & Al–Sa'eed 'Features of an effective audit committee, and its role in strengthening the financial reporting: Evidence from Amman Stock Exchange' (2011) vol. 1, no. 1 *Journal of Public Administration and Governance* 49; Beasley et al 'The Audit Committee Oversight Process' (2009) 26 (1) *Contemporary Accounting Research* 70; Also see Public Sector Audit Committee Forum 'The Relationship between Audit Committees and Governing Bodies' 5, available at https://www.psacf.co.za/page/GuidancePapers (accessed on 10 July 2020); Recommended Practice 51 under Principle 8 of Part 5.3 of the *King IV Code;* Global Institute of Internal Auditors 'Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations' (June 2014) 4.

and recommendations are appropriately addressed by the board of directors through the company's management.[653] For the internal audit function, proper oversight by an effective audit committee could significantly contribute to a strong system of internal controls and reduce the likelihood of fraudulent activities.[654] In this regard, the performance and effectiveness of the internal audit function should be reviewed and assessed by the company's audit committee at least on an annual basis.[655] Further, the audit committee must satisfy itself that the reporting structure of the internal audit function reflects its independence and objectivity.[656]

The OECD recommends that the company's audit committee should provide oversight over the internal audit activities of the company and should also be assigned the function of overseeing the overall relationship with the external auditor.[657] The oversight of the work of the company's external auditor is particularly important if the external audit also provides non-audit service to the company. In this respect, the provision of non-audit services by the external auditor to a company can significantly impair the external auditor's independence and might involve the auditor's auditing of its own work.[658] It is for this reason that the audit committee must determine the nature and extent of any non-audit services which an external auditor may or may not provide to the company and provide pre-approval thereto.

As the responsibilities of the audit committee extend to both the internal and external audit function of the company,[659] it is suggested that, as a matter of best practice, the audit committee should define in its charter the scope of its relationship with the auditors[660] and review such audit charter annually.[661] This could ensure that there is a framework in place to enhance and protect the level of independence of the

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[653] Marx B (2008) 292.
[654] Marx B (2008) 294.
[655] Marx B (2008) 292.
[656] Van der Nest DP 'The perceived effectiveness of audit committees in the South African public service' (2008) vol. 16(2) *Meditari Accountancy Research* 180.
[657] OECD (2015) G20/OECD Principles of Corporate Governance, OECD Publishing, Paris 43.
[658] OECD (2015) G20/OECD Principles of Corporate Governance, OECD Publishing, Paris 43.
[659] Van der Nest DP 'The perceived effectiveness of audit committees in the South African public service' (2008) vol. 16(2) *Meditari Accountancy Research* 179.
[660] Global Institute of Internal Auditors 'Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations' (June 2014) 35.
[661] Global Institute of Internal Auditors 'Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations' (June 2014) 29.

audit function. The independence of the company's auditor is important for exposing the company's financial and internal control problems.[662]

Zhang, Zhou and Zhou express the view that where there is economic bond between the company and its auditor, the auditor has an incentive to ignore potential problems and issue a clean opinion on the company's internal controls.[663] This supports the view that the independence of company's audit committee must be protected from any undue influence and interference by the company's governing body, so as to create an environment within which the audit committee may provide an independent oversight on the company's audit function for the benefit of stakeholder community.

3.3.2.2 Legislative and regulatory compliance oversight

As propounded in Chapter 2, the term corporate governance should also be defined from the perspective of the culture of legislative and regulatory compliance by corporate leadership. This is deduced from the standpoint that the company's audit committee plays an integral part of corporate governance in general and compliance in particular. Turley and Zaman assert that the audit committee is expected to monitor the reliability of the company's accounting processes and compliance with corporate legal and ethical standards, including the maintenance of preventive fraud controls.[664] It may be added that, with regards to financial reporting, the role of the audit committee is to ensure that the company's financial reporting complies with the relevant financial reporting regulatory framework such as, for example, the International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS).

It must be underscored that compliance in this regard does not mean establishment of the audit committee to comply with the relevant statutory and regulatory codes, but rather the efficiency of the audit committee to ensure the company's compliance

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[662] Zhang Y, Zhou J & Zhou N 'Audit committee quality, auditor independence, and internal control weaknesses' (2007) 26 *Journal of Accounting and Public Policy* 306.
[663] Zhang Y, Zhou J & Zhou N 'Audit committee quality, auditor independence, and internal control weaknesses' (2007) 26 *Journal of Accounting and Public Policy* 306.
[664] Turley S & Zaman M 'The Corporate Governance Effects of Audit Committees' (2004) 8 *Journal of Management and Governance* 309.

with all applicable laws and codes. Therefore, the audit committee is not, in and of itself, compliance. Instead, it is a mechanism to achieve governance compliance. In other words, the mere existence of the audit committee does not reduce the occurrence of information asymmetry and non-compliance.[665] Its independence and protection thereof are essential for its effective functioning to promote legislative and regulatory compliance.

The audit committee's compliance oversight function includes the evaluation of the company's financial reporting and compliance procedures.[666] To achieve this, the audit committee must review the company's financial statements with specific focus on issues such as materiality, compliance with accounting policies and standards, significant changes and areas susceptible for fraud.[667] It is for this reason that the various corporate governance codes normally task the audit committee with the responsibility of overseeing the company's compliance with laws and regulations and the company's code of conduct.[668]

3.3.2.3 Financial reporting

The audit committee has an important financial oversight responsibility in relation to financial reporting.[669] Its main objective is to improve the quality of the financial reporting process and the accuracy, integrity and reliability of the financial statements.[670] It is, therefore, essential that members of the audit committee have the necessary understanding, experience and expertise regarding financial reporting, controls and audit aspects.[671]

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[665] Bhasin 'Strengthening corporate governance through an audit committee: An empirical study' (2016) vol 23 no. 2 *Wulfenia Journal* 6.

[666] van der Nest et al 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 554.

[667] van der Nest et al 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 550.

[668] Marx B & Els G 'The role of the audit committee in strengthening business ethics and protecting stakeholders' interests' (2009) vol. 4 No. 1 *African Journal of Business Ethics* 7.

[669] Marx B & du Toit E 'The impact of accounting standards developments and financial reporting complexities on the audit committee' (2009) 3(2) *Journal of Economic and Financial Sciences* 121.

[670] Marx B & Els G 'The role of the audit committee in strengthening business ethics and protecting stakeholders' interests' (2009) vol. 4 No. 1 *African Journal of Business Ethics* 8.

[671] Marx B & Els G 'The role of the audit committee in strengthening business ethics and protecting stakeholders' interests' (2009) vol. 4 No. 1 *African Journal of Business Ethics* 8.

The audit committee's role in overseeing the financial reporting process cannot be separated from the independence of its members[672] and the committee as a whole. As the cornerstone of audit committee's efficacy, independence makes audit committee more autonomous and free from any vested interests.[673] The effectiveness of the audit committee's financial reporting function and reduction of financial reporting manipulation would only be possible if the committee is independent and enjoys freedom from the influence of the company's board of directors and management.[674]

Beasley *et al*[675] undertook a study to examine the question whether audit committees appear to provide substantive oversight of financial reporting, or do they appear to be primarily ceremonial bodies designed to create legitimacy?[676] In answering this question, the study established that many audit committee members strive to provide effective monitoring of financial reporting and seek to avoid serving on ceremonial audit committees.[677] Avoiding or even refusing to serve on ceremonial capacity, the audit committee and its individual members are exposed to possible unbearable levels of hostility from the company's governing bodies (boards of directors and accounting authorities), thus amplifying the need for sufficient independence and protection of the audit committee from the governing bodies. Notwithstanding, the *King IV Report* recommends that the audit committee should disclose significant matters in relation to the company's annual financial statements and how such matters were addressed by the committee.[678]

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[672] Chariri A & Januarti I 'Audit Committee Characteristics and Integrated Reporting: Empirical Study of Companies Listed on the Johannesburg Stock Exchange' (2017) vol XX issue 4B *European Research Studies Journal* 308.
[673] Chariri A & Januarti I 'Audit Committee Characteristics and Integrated Reporting: Empirical Study of Companies Listed on the Johannesburg Stock Exchange' (2017) vol XX issue 4B *European Research Studies Journal* 308.
[674] Chariri A & Januarti I 'Audit Committee Characteristics and Integrated Reporting: Empirical Study of Companies Listed on the Johannesburg Stock Exchange' (2017) vol XX issue 4B *European Research Studies Journal* 309.
[675] Beasley et al 'The Audit Committee Oversight Process' (2009) 26 (1) *Contemporary Accounting Research* 65-122.
[676] Beasley et al 'The Audit Committee Oversight Process' (2009) 26 (1) *Contemporary Accounting Research* 66.
[677] Beasley et al 'The Audit Committee Oversight Process' (2009) 26 (1) *Contemporary Accounting Research* 66.
[678] Recommended Practice 59.b. under Principle 8 of Part 5.3 of the *King IV Code.*

3.3.2.4 Management oversight

One of the most crucial responsibilities of the audit committee is to provide oversight over the company's executive management, on behalf of the governing body.[679] However, this responsibility does not come without corporate governance dilemma, especially where some audit committee members do have or have developed some friendly relationship with the company's management or part thereof. This is evidenced by the global high profile financial irregularities, corporate governance challenges and downright corruption, which happened within corporations, despite the fact that majority of such corporations had audit committees.[680]

In a study undertaken by Bruynseel and Cardinaels,[681] the authors express the view that audit committee members can be linked to executive directors and management in a number of ways.[682] A good example is where members of the audit committee and members of the executive management may have served together in the past as directors on the board of another company. Another example would be where some members of the audit committee and members of the management team had worked together in the past as directors or employees. The authors make a further example where members of the audit committee and members of the management may have attended the same university or even where they are or were members of the same golf club.[683] It is submitted that this is also true in respect of links between members of the audit committee and members of that company's board of directors. In this regard, the audit committee's independent oversight of the company's management may be compromised by the individual ties. Bruynseel and Cardinaels further observed that if an ostensibly independent audit committee has any links with the company's management, especially the CEO, then such audit

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[679] Smith LM 'Audit committee effectiveness: did the blue ribbon committee recommendations make a difference?' (2006) 3(2) *Int. J. Accounting, Auditing and Performance Evaluation* 244.

[680] For some examples of some high profile financial irregularities and corporate governance collapses, see Mallin AC *Corporate Governance* 6 ed (2018) 2-8. Other examples include the VBS bank, Tongaat Hulett Limited and the SAA scandals.

[681] Bruynseel L & Cardinaels E 'The Audit Committee: Management Watchdog or Personal Friend of the CEO?' June 6, 2013.

[682] Bruynseel L & Cardinaels E 'The Audit Committee: Management Watchdog or Personal Friend of the CEO?' June 6, 2013 5.

[683] Bruynseel L & Cardinaels E 'The Audit Committee: Management Watchdog or Personal Friend of the CEO?' June 6, 2013 1.

committee cannot be considered to be truly independent.[684] It is also suggested that the audit committee does not always act in the interest of company and its stakeholders and that its role is sometimes reduced to a ceremonial one.[685]

The foregoing represents circumstances where members of the audit committee or the committee as a whole may serve in a ceremonial capacity as unofficial personal friends of the company's governing body or the executive management. Crucially, the fact that the Companies Act 2008 empowers the board of directors to appoint and analogously remove members of the company's audit committee may incentivise members of the audit committee to toe the line, thus weaken the committee's independence.

3.3.2.5 Risk management

Risk management is the responsibility of the company's board of directors, delegated to the management, to assess the potential impact of negative events on the company.[686] Effective risk management is one of the key aspects for the realisation of the business objectives. The company's audit committee is often responsible for overseeing the management's assessment of and response to the business risk, to strengthen management's ability to identify and assess both internal and external risks.[687] In this respect, the audit committee is required to assess management's risk management processes and both the internal and external auditing's coverage of these risks.[688]

In some corporations, the risk management function is assigned to the company's audit committee.[689] The reason for this may be located within the criticism from the

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[684] Bruynseel L & Cardinaels E 'The Audit Committee: Management Watchdog or Personal Friend of the CEO?' June 6, 2013 6.
[685] Bruynseel L & Cardinaels E 'The Audit Committee: Management Watchdog or Personal Friend of the CEO?' June 6, 2013 32.
[686] Van der Nest DP 'The perceived effectiveness of audit committees in the South African public service' (2008) vol. 16(2) *Meditari Accountancy Research* 178.
[687] Turley S & Zaman M 'The Corporate Governance Effects of Audit Committees' (2004) 8 *Journal of Management and Governance* 309.
[688] Van der Nest DP 'The perceived effectiveness of audit committees in the South African public service' (2008) vol. 16(2) *Meditari Accountancy Research* 182.
[689] For example, the board of directors of the SAA has or had a subcommittee called Audit and Risk Committee (see the Judicial Commission of Inquiry into allegations of State Capture, Corruption and Fraud in the Public Sector including Organs of State Report: Part 1 Vol. 1: Chapter 1 – South African Airways and its Associated Companies at para 30). Also see the Report of the Judicial

stakeholder community, namely that the existence of a standalone risk management committee may result in overlapping of responsibilities between the risk management committee and the audit committee.[690] However, the separation of the risk committee from the audit committee may be ideal for large and complex corporations. For example, the Judicial Commission of Enquiry into Allegations of Impropriety at the Public Investment Corporation Limited ('the PIC Report') recommended that the risk and audit committees should be separated and each should stand alone.[691] This is presumably to ensure that each committee is able to function optimally and effectively, by focusing on a specific mandate under its purview and to reduce the likelihood of risk materialisation and corporate governance collapses. The Public Investment Corporation Limited is one of the South African public entities which were marred by serious allegations of fraud, corruption, malfeasance and complete corporate governance failures in the recent years, despite the fact that the corporation had the audit committee.[692] Nonetheless, where the board of directors and accounting authorities resolves to combine the risk management committee and the audit committee, the audit committee must satisfy itself that it has sufficient time for the risk management responsibility.[693] It is further recommended that where the audit committee and the risk committee are separate, companies should consider one or more members to have joint membership of both committees for more effective functioning.[694]

It is submitted that where the risk management function is delegated to the company's audit committee, the committee must be accorded the necessary independence to implement and monitor policies and processes to effectively manage risks for the benefit of the company and its congregation of stakeholders.

Commission of Enquiry into Allegations of Impropriety at the Public Investment Corporation, Proclamation No. 30 of 2018 (the 'PIC Report') , where it was recommended that the Risk and Audit Committees of the PIC should be separated and each be a standalone committee (see para 62, pp 133 of the PIC Report).

[690] Larasati DA et al 'Independent audit committee, risk management' (2019) 6: 1707042 *Cogent Business & Management* 3.

[691] See the *PIC Report* (Proclamation No. 30 of 2018) para 62.

[692] See the Report of the Judicial Commission of Enquiry into Allegations of Impropriety at the Public Investment Corporation, Proclamation No. 30 of 2018 (the 'PIC Report') , where it was recommended that the Risk and Audit Committees of the PIC should be separated and each be a standalone committee (see para 62, pp 133 of the PIC Report).

[693] Recommended Practice 53 under Principle 8 of Part 5.3 of the *King IV Code.*

[694] Recommended Practice 63 under Principle 8 of Part 5.3 of the *King IV Code.*

An independent audit committee comprising knowledgeable members is in a good position to pose the right questions to determine whether the company is managing risk adequately.[695] Even if the risk governance is not assigned to the company's audit committee, the committee should provide oversight on the management of financial and other risks which affect the external reports issued by the company.[696] As an independent organ of the company, the audit committee may regularly report to the board of directors on its risk management performance but should be accountable only to the company's shareholders in a meeting. This will ensure that the independence of the committee is sufficiently protected from interference by the dissenting board of directors and management.

3.3.2.6 Internal controls and combined assurance

The next exposition will demonstrate that the audit function oversight responsibility of the audit committee also extends to the combined assurance. A combined assurance model is defined as a model which incorporates and optimises all assurance services and functions so that, taken as a whole, they enable an effective control environment.[697] This model also supports the integrity of the information used for internal decision-making by management, the board directors and its committees, as well as supporting the integrity of the company's external reports.[698] It is an assessment by the various assurance providers of level of risk mitigation and assurance being provided over risk, control, information and reports.[699] The audit committee is required to provide an independent oversight of the effectiveness of the company's assurance functions and services, focusing particularly on the combined assurance including, among others, external assurance services and finance functions.[700] In this respect, the board of directors and audit committee

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[695] van der Nest et al 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 550.
[696] Recommended Practice 54 under Principle 8 of Part 5.3 of the *King IV Code.* Also see Marx B (2008) 87.
[697] *King IV Report* (2016) 10.
[698] *King IV Report* (2016) 10.
[699] Deloitte Audit Committee Resource Guide (2017) 37.
[700] Recommended Practice 51.a under Principle 8 of Part 5.3 of the *King IV Code.*

should approve the policy to ensure that the necessary oversight of and alignment with the combined assurance process is in place.[701]

Arguably, the evaluation of internal controls is the second most important audit committee oversight function after financial statement review.[702] The responsibilities of audit committee, in so far as they relate to the system of internal controls, includes the evaluation of the procedures implemented by management, on behalf of the board, in order to address internal control issues as identified through the risk management process and in audit reports.[703] The audit committee must be given assurance that the accounting and information systems and related controls are adequate and effective.[704] It is argued that the quality of, among other things, the system of internal controls necessitates an independent audit committee that acts as a link between management, internal and external audit.[705]

As empirical evidence suggests that the independence of the audit committee and its financial expertise are associated with better quality of internal controls,[706] the need for mechanisms to adequately safeguard the independence of the audit committee cannot be overemphasised. This would not only strengthen the company's internal controls environment but also improve the corporate governance and financial performance of the company.

3.3.2.7 Advisory role

The audit committee may also play an advisory role in the company.[707] This is aimed at corporate governance performance improvement within the company. It is suggested that, with greater level of independence and protection thereof, the audit

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[701] Deloitte Audit Committee Resource Guide (2017) 38.

[702] Turley S & Zaman M 'The Corporate Governance Effects of Audit Committees' (2004) 8 *Journal of Management and Governance* 318.

[703] van der Nest et al 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 550.

[704] van der Nest et al 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 550.

[705] van der Nest et al 'Audit committee and accountability in the South African Public Sector' (2008) vol 43 (4) *Journal of Public Administration* 549.

[706] Ghafran C & O'Sullivan N 'The Governance Role of Audit Committees: Reviewing a Decade of Evidence' (2012) vol 15(4) *International Journal of Management Reviews* 16.

[707] Akwenye NJ, Chata T & Benedict OH 'Establishment of audit committee in government ministries of a developing country' (2016) 6(4) *Risk Governance & Control: Financial Markets & Institutions* 285.

committee would be able to add value to the company through objective and impartial advice.[708] In discharging its advisory responsibilities, the audit committee should strike an appropriate balance between its oversight and advisory functions, and avoid micromanaging the company's management.[709] The audit committee must also not be involved in the board and management decision-making. The danger which comes with the audit committee's involvement in the board's or management's decision-making is that its objectivity may be compromised, which may lead to negative impact on its ability to remain independent.[710]

The audit committee should also advise the governing body (board of directors and accounting authorities) on the adequacy of resource requirements for the planned audit activities, including the skills and competence to successfully execute the audit plans.[711] The purpose is to strive for continuous improvement of the effectiveness of the company's audit function. In this respect, the advice would include suggestions and recommendations[712] to strengthen the company's corporate governance structure in general and the integrity of the financial reporting in particular.

It recommended that the audit committee should provide its independent view of the effectiveness of the company's Chief Financial Officer ('CFO') and the finance function.[713] This means that the audit committee is expected to advise the board of directors on whether the CFO is able to perform his or her functions effectively within the corporate governance framework. Further, the audit committee also has the responsibility to advise the governing body regarding the qualifications and recruitment, retention, and termination of the services of the company's Chief Audit Executive ('CAE').[714] In other words, the audit committee must assess the suitability

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[708] Magrane J & Malthus S 'Audit Committee Effectiveness: A Public Sector Case Study' (2010) vol. 25 Iss: 5 *Managerial Auditing Journal* 19.
[709] Marx B (2008) 2.
[710] Global Institute of Internal Auditors 'Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations' (June 2014) 6.
[711] Global Institute of Internal Auditors 'Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations' (June 2014) 9.
[712] Global Institute of Internal Auditors 'Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations' (June 2014) 9.
[713] Recommended Practice 59.f under Principle 8 of Part 5.3 of the *King IV Code.*
[714] Global Institute of Internal Auditors 'Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations' (June 2014) 29.

of the company's CAE and advise the company's board of directors whether the CAE may serve or continue to serve in that capacity.

Significantly, the responsibilities of the audit committee may also include the reviewing of and advising management on the results of any special investigations.[715] Presumably, such investigations may include forensic investigations of financial nature and other investigations of pure audit nature.[716] For public entities, the PFMA prescribes that the audit committee must be provided with the resources it needs to investigate such matters and shall have full access to information.[717] The PFMA further empowers the audit committee of the public entity to report, through its chairperson, to the relevant executive authority and the Auditor-General any information which implicates any member of the entity's accounting authority in fraud, corruption or gross negligence.[718] It is conceivable that an audit committee with compromised independence would find difficulties discharging these responsibilities. For this reason, the audit committee should be accorded the necessary protection, so that it may perform its advisory and reporting duties without any prejudice or fear of reprisal.

3.4 CONCLUSION

The purpose of this chapter was to highlight the importance of the composition of the company's audit committee, in so far as it may strengthen or weaken its independence. The size of the committee does matter. The smaller the size of the audit committee, the higher the probability of that audit committee lacking the necessary diversity of skills and expertise. Conversely, a bloated audit committee may lack the necessary effectiveness. Therefore, while the size of the company's audit committee must be structured in relation to the magnitude and the nature of the company, the independence of the committee and protection thereof must not be compromised. It has also been shown in this chapter that the manner in which members of the audit committee are appointed and removed has a critical direct

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[715] Global Institute of Internal Auditors 'Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations' (June 2014) 29.
[716] For example, the audit committee could review and offer advice on the investigation of possible financial fraud or investigation of control weaknesses.
[717] Regulation 27.1.9 of the Treasury Regulation for PFMA.
[718] Regulation 27.1.11 of the Treasury Regulation for PFMA.

effect on level of independence of the committee.[719] The governing bodies such as the board of directors of privately-owned companies and accounting authorities of public entities have the powers to constitute and appoint members of the audit committee. Consequently, these governing bodies also have the corollary powers to remove members of the audit committee before end of the term of office. Although the shareholders are empowered to elect and appoint members of the company's audit committee at the annual general meetings, they play a very nominal or no role in the premature termination of the committee membership. This may increase the likelihood of governing bodies' abuse of power and interference with the functioning of the audit committee to advance their own personal interests, to the detriment of the company's community of stakeholders. In this regard, a recommendation will be made in Chapter 6 on how the relevant provisions of the Companies Act 2008 and the PFMA could be enhanced to make provision for the protection of members of the audit committee and the committee's independence.

The functions and duties of the audit committee as discussed in this chapter[720] represent the centrality of the role of the audit committee in the governance of corporations globally. It must be stated that, it is by no stretch of imagination that the audit committee could be seen to be a mechanism with which corporate fraud and financial misstatements within companies could be eradicated. However, an independent audit committee could assist to ascertain the quality and integrity of the financial and other material information provided to the companies' stakeholders community. This would, in turn, assist the stakeholders to make informed decisions. The functions and duties of the company's audit committee were discussed in two segments. The first segment dealt with the statutory duties of the audit committee as set out in the Companies Act 2008 and the PFMA. It is submitted that these statutory functions and duties are obligatory for the audit committee despite whether the audit committee was established mandatorily or voluntarily. It is further submitted that these statutory duties may not be negated, restricted, limited, qualified, extended or otherwise altered in substance or effect by the company's

[719] See Point 3.2 in Chapter 3 of this thesis which dealt with the composition, appointment and removal of members of the audit committee and how this affects the audit committee's independence

[720] See Point 3.3 in Chapter 3 of this thesis.

MOI or any resolution of the board of directors or shareholders. For example, the company may not resolve to remove the function of determining audit fees and the auditors' terms of engagement from the company's audit committee and assign such function to another committee. Any possible alterability of these statutory duties would disarm the audit committee. The second segment highlighted a number of functions and duties which, although not set out in the Companies Act 2008 or the PFMA as the functions and duties of the audit committee, may, nonetheless, be delegated to the audit committee by the governing body. The delegation of these duties may vary from corporation to corporation and may depend on the size and complexity of the company. For example, a large corporation may decide to separate the risk committee from the audit committee and delegate the entire risk function to the company's risk committee.

The exposition in this chapter also showed that the role, functions and duties of the audit committee are too vital to be battered by any level of internal or external interference. The duties of the audit committee are the duties which can only be discharged by an impartial body, which acts independently without fear of reprisal or favour towards the board of directors, shareholders or any other individual. It is for this reason that the independence of the audit committee must enjoy sufficient protection under the Companies Act 2008 and the PFMA, to improve corporate performance and reduce the risk of governance catastrophes for the benefit of the company and the greater stakeholder community.

The next chapter examines some international best practices in the domain of the audit committee. The chapter traverses various legislative and governance frameworks in the UK and USA in so far as they deal with the independence of the audit committee and protection thereof. The purpose of this comparison is to establish whether or not South Africa may draw any valuable lessons from these jurisdictions. This will be achieved by interrogating how the UK and the USA company law jurisprudences regulate audit committees and how the independence of such committees is safeguarded.

CHAPTER 4: INTERNATIONAL BEST PRACTICES WITH RESPECT TO INDEPENDENCE OF AUDIT COMMITTEES

4.1 INTRODUCTION

As an essential corporate governance mechanism, the concept of audit committee is a global phenomenon.[721] Although the concept has been in existence for decades, it appears to have endured a number of challenges globally. This is evinced by the introduction and revision of corporate governance codes in some countries to enhance transparency and accountability.[722] For example, the UK has gone through a number of corporate governance challenges which resulted in the development and publication of a series of various governance reports and codes,[723] such as the Cadbury Report[724] in 1992, the Smith Report[725] in 2003, the Combined Code in 1998, 2003, 2006 and 2008,[726] and the UK Corporate Governance Code in 2010, 2012, 2014, 2016 and 2018.[727] Similarly, the corporate governance scandals and financial reporting irregularities in the USA have led to the promulgation of SOX Act in that country.[728]

This chapter focuses on various legislative and governance frameworks in the UK and USA in so far as they deal with the independence of the audit committee and protection thereof. While the USA SOX Act has had an influence on corporate governance in many countries including South Africa, the South African company law has a rich English law heritage.[729] The enduring influence of English law in South Africa dates back to the middle of the nineteenth century.[730] The previous company

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[721] See Akwenye NJ, Chata T & Benedict OH 'Establishment of audit committee in government ministries of a developing country' (2016) 6(4) *Risk Governance & Control: Financial Markets & Institutions* 282.
[722] See Mallin AC *Corporate Governance* 6 ed (2018) 30.
[723] Mallin AC *Corporate Governance* 6 ed (2018) 31.
[724] Financial Reporting Council's 'Report of the Committee on The Financial Aspects of Corporate Governance' (1992) (Cadbury Report (1992)).
[725] Financial Reporting Council's 'Audit Committees Combined Code Guidance' (2003) (Smith Report (2003)).
[726] Financial Reporting Council 'The Combined Code on Corporate Governance' (2008).
[727] Financial Reporting Council 'The UK Corporate Governance Code' (2018); See a brief discussion of various UK governance codes in Mallin AC *Corporate Governance* 6 ed (2018) 31-44.
[728] Smith LM 'Audit committee effectiveness: did the blue ribbon committee recommendations make a difference?' (2006) 3(2) *Int. J. Accounting, Auditing and Performance Evaluation* 240-241.
[729] South African Company Law for the 21st Century, Guidelines for Corporate Law Reform (GN 1183 in GG 26493 of 23 June 2004) 12.
[730] South African Company Law for the 21st Century, Guidelines for Corporate Law Reform (GN

law frameworks[731], and to some extent the current company legislation,[732] were founded upon the principles of English company law.[733] It is thus not surprising that South Africa has faced similar corporate governance challenges as the UK and the USA. It is for this reason that this comparative study examines the independence of audit committees and protection thereof in these jurisdictions.

Chapter 4 is structured to examine the UK and USA jurisdictions in separate segments. It starts by exploring the development of the audit committee in the UK, and the legislative and corporate governance framework which governs and protects the independence of audit committees in that country. After this discussion, the chapter proceeds to draw a comparison between the UK and South African jurisdictions in respect of audit committee independence and protection thereof. Similarly, this chapter also explores the development and legislative framework of audit committees in the USA, and highlights lessons which South Africa may draw from that jurisdiction.

The objective of this comparison is to measure how the UK and the USA company law jurisprudences deal with the independence of the audit committee and how such independence is safeguarded. The aim is to establish whether or not South Africa may draw any lessons from those advanced economies.

4.2 CORPORATE GOVERNANCE AND THE AUDIT COMMITTEE IN THE UK

4.2.1 The genesis of the audit committee in the UK

As pointed out in Chapter 1,[734] the first audit committee was introduced as far back as 1872 by the Great Western Railway Company in the UK.[735] However, it was the widely reported financial scandals and general decline of confidence in the financial reporting of many UK companies, which resulted in the establishment of a

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1183 in GG 26493 of 23 June 2004) 12.

[731] Under Companies Act 46 of 1926 and later under the Companies Act 61 of 1973.

[732] The Companies Act 71 of 2008.

[733] South African Company Law for the 21st Century, Guidelines for Corporate Law Reform (GN 1183 in GG 26493 of 23 June 2004) 12. Also see Botha MM 'The role and duties of directors in the promotion of corporate governance: A South African Perspective' (2009) *Obiter* 704.

[734] See Point 1.1.3.1 in Chapter 1 of this thesis.

[735] See Marx B (2008) 1; Also see Marx B & Du Toit E (2009) 116.

committee on the Financial Aspects of Corporate Governance in 1991.[736] The committee was set up by the Financial Reporting Council ('FRC'), the London Stock Exchange ('LSE') and the accountancy profession to address the financial aspects of corporate governance in the UK.[737] At the conclusion of its work, this committee produced a report called the Cadbury Report, which was named after the chairperson of that committee, Sir Adrian Cadbury, in 1992. The Cadbury Report (1992) contained a recommended Code of Best Practice with which the UK companies had to comply.[738] After the publication of the Cadbury Report (1992), the concept of the audit committee became a standard feature of corporate governance in the UK, principally among the listed companies.[739]

In 2002, the FRC, which is the UK's independent audit regulator, set up a committee to review the institution of the audit committee. This committee was chaired by Sir Robert Smith to assist in the development of the then existing audit committee guidelines in the UK and it became known as the Smith Committee.[740] The Smith Committee was formed as the UK's response to the reported corporate scandals in the USA.[741] At the conclusion of its work, the Smith Committee produced a report titled the 'Audit Committees Combined Code Guidance', commonly known as the Smith Report, in 2003. The Smith Report (2003) stated the importance of the audit committee as follows:

> While all directors have a duty to act in the interests of the company, the audit committee has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal controls.[742]

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[736] The reasons for setting up this committee are set out in the *Cadbury Report* (1992) at paras 2.1-2.4.
[737] *Cadbury Report* (1992) para 2.1.
[738] Mallin AC *Corporate Governance* 6 ed (2018) 33.
[739] Marx B (2008) 31.
[740] AccoutingWeb 'Smith report on audit committees - a summary' 12th Mar 2003 available at https://www.accountingweb.co.uk/business/financial-reporting/smith-report-on-audit-committees-a-summary#:~:text=The%20report%20of%20the%20Smith,and%20published%20in%20January%202003.&text=Smith%20indicates%20that%20where%20a,Monitor%20integrity%20of%20accounts (accessed on 26 April 2021).
[741] Marx B (2008) 104. The corporate governance failures in the USA were reported in the highly publicised scandals in Enron, WorldCom and McKesson & Robbins Incorporated.
[742] *Smith Report* (2003) para 1.5. Also see Mallin AC *Corporate Governance* 6 ed (2018) 35.

The recommendations of the Cadbury Report (1992), the Smith Report (2003) and other various governance codes are consolidated into a governance code titled UK Governance Code issued by FRC, with the latest version released in July 2018.[743]

4.2.2 Legislative and governance framework for the audit committee in the UK

The UK's company law regime is governed by the Companies Act 2006 (c 46) ('the UK Companies Act 2006') as the primary governance framework in that country. The UK Companies Act 2006 is a creation of years of thorough review of the UK's corporate law.[744] It features some of the key common law principles of corporate law, such as the appointment and removal of directors of the company;[745] codified directors' duties;[746] directors' liabilities;[747] companies' accounting records;[748] and provisions which regulate the appointment, removal and duties of company auditors.[749] Surprisingly, there are no provisions in the UK Companies Act 2006 which govern the establishment and maintenance of the system of audit committees for the UK companies.

The scheme of audit committees for UK companies is prescribed in that country's various and series of governance codes and reports, notably the Cadbury Report (1992), the Smith Report (2003), guidance on Audit Committee (2016) and the UK governance code (2018). As it will be demonstrated below, the UK governance code prescribes that audit committees of the UK companies be comprised of independent non-executive directors.[750] Section 173 of the UK Companies Act 2006 requires the directors of the company to exercise independent judgment. Presumably, this includes independent non-executive directors who serve on audit committees in that jurisdiction.

[743] Financial Reporting Council 'The UK Corporate Governance Code' (2018) available at https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-Final.PDF (accessed on 06 May 2021).
[744] Mallin AC *Corporate Governance* 6 ed (2018) 48.
[745] Part 10 Chapter 1 of the Companies Act 2006 (c46).
[746] Part 10 Chapter 2 of the Companies Act 2006 (c46).
[747] Part 10 Chapter 7 of the Companies Act 2006 (c46).
[748] Part 15 Chapter 2 of the Companies Act 2006 (c46).
[749] Part 16 of the Companies Act 2006 (c46).
[750] See UK Governance Code (2018) para 24.

4.2.2.1 Cadbury Report (1992)

For the UK, the Cadbury Report (1992) was motivated by the development of the audit committee in the USA. The Cadbury Report (1992) notes that, though audit committees were initially set up primarily to meet listing requirements, they have developed into essential committees of boards of directors.[751] Accordingly, the Cadbury Report (1992) recommended the Code of Best Practice with which the UK listed companies should comply, employing the principle of 'comply or explain'.[752] The principle of 'comply or explain' means that companies had to comply with the recommended Code of Best Practice or the non-compliance had to be explained.[753] The Code of Best Practice recommends that all listed companies should establish an audit committee[754] and that such committee should have a 'clear relationship with the boards to whom they are answerable and to whom they should report regularly'.[755] Seemingly, the Cadbury Report (1992) had envisaged the audit committee to be a committee of the board of directors, which functions under the direction and control of that board. This is further evidenced by the provisions of paragraph 4.36 of the Cadbury Report (1992), which states that the board of directors should appoint an audit committee, rather than aiming to carry out the functions of the audit committee by itself.

The Code of Best Practice recommends that the audit committee should comprise a minimum of three members, who should be non-executive directors.[756] Among other benefits, the Cadbury Report (1992) highlights the benefit of the audit committee as having a separate committee which enables the board of directors to delegate the thorough and detailed review of the audit related matters to it. A separate committee further allows the non-executive directors to contribute an independent judgment to that committee and offers the external auditor a direct link with non-executive directors.[757]

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[751] See *Cadbury Report* (1992) para 4.34.
[752] See Mallin AC *Corporate Governance* 6 ed (2018) 52.
[753] See Mallin AC *Corporate Governance* 6 ed (2018) 46.
[754] *Cadbury Report* (1992) para 4.35.
[755] *Cadbury Report* (1992) para 4.35(a).
[756] *Cadbury Report* (1992) para 4.35(b).
[757] *Cadbury Report* (1992) para 4.36.

The duties of the audit committee are recorded in paragraph 4.35(e) of the Cadbury Report (1992). Crucially, the Cadbury Report (1992) recommends that the audit committee should recommend to the board of directors the appointment and removal of the external auditors and audit fees;[758] oversee the internal audit function;[759] and carry out the review of financial statements[760] and internal control systems.[761] This highlights the importance of the oversight role of the audit committee in respect of the system of internal controls, financial reporting and combined assurance. It must be noted that the Cadbury Report (1992) does not recommend the necessary mechanisms or processes for appointment and removal of members of the audit committee from such committee. This omission was partly addressed in the Smith Report (2003), which is discussed in detail below.

4.2.2.2 Smith Report (2003)

The Smith Report (2003) is officially titled the *Audit Committees Combined Code Guidance*, which is designed to 'assist company boards in making suitable arrangements for their audit committees, and to assist directors serving on audit committees in carrying out their role'.[762] As already highlighted, the Smith Report (2003) notes that while all directors of the company have a duty to act in the interests of the company, the audit committee is particularly expected to act independently from the executive directors. This is to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal controls.[763] Flowing from the foregoing, it is submitted that the Smith Report (2003) does not consider the audit committee to be an ordinary committee of the board of directors. The Smith Report (2003) further recognises the fact that some companies may not be able to meet the requirements, particular companies which have fewer than three non-executive and independent directors.[764] In this respect, the Smith Report (2003) adopted the 'comply or explain' approach, which encourages all listed companies to

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[758] *Cadbury Report* (1992) para 4.36(i).
[759] *Cadbury Report* (1992) para 4.36(f)
[760] *Cadbury Report* (1992) para 4.36(ii).
[761] *Cadbury Report* (1992) para 4.36(v).
[762] *Smith Report* (2003) para 1.1.
[763] *Smith Report* (2003) para 1.5.
[764] *Smith Report* (2003) para 1.3.

comply and where compliance is inappropriate or not possible, the non-compliance must be explained.[765]

The Smith Report (2003) retained the recommendation of the Cadbury Report (1992) in respect of the membership to and the duties of the audit committee.[766] Additionally, it further recommended that the chairperson of the company's board of directors should not be a member of that company's audit committee.[767] While it may be accepted that the chairperson may be a dominant figure on the board of directors and therefore should not be a member of the audit committee, it is submitted that it makes no difference in instances where the chairperson is allowed to be a member of the nomination committee. The reason for this is that paragraph 3.3 of the Smith Report (2003) recommends that, where applicable, the appointment of members of the audit committee should be made by the board of directors on recommendation by the nomination committee. It is also not clear whether the chairperson of the board may or may not be a member of the nomination committee for the purpose of nomination of members of the audit committee. Nonetheless, members of the audit committee may serve on the committee for a period of up to three years, renewable for a further two sets of three year periods, provided the members' independence continues to be sustained.[768] Like the Cadbury Report (1992), the Smith Report (2003) uninspiringly does not set out any recommended mechanisms or processes for appointment and removal of members of the audit committee from such committee before the end of term of office.

4.2.2.3 Guidance on Audit Committees (2016)

The Guidance on Audit Committees (2016) is a short document which preserves most and arguably the exact texts that appeared in the previous reports, that is the Cadbury and Smith Reports discussed above. Like the Smith Report (2003), the purpose of Guidance on Audit Committees (2016) is to assist boards of directors to make suitable arrangements for audit committees and assist directors serving on

[765] *Smith Report* (2003) para 1.3.
[766] See *Smith Report* (2003) paras 3 and 5.
[767] *Smith Report* (2003) para 3.2.
[768] *Smith Report* (2003) para 3.4.

the audit committee in carrying out their role.[769] The Guidance on Audit Committees (2016) contains a summary of requirements for establishment of the audit committee and its effectiveness; the role and duties of the audit committee and the communication between the audit committee and the shareholders.

As noted above, the audit committee guidelines contained in the Guidance on Audit Committees (2016) are not different to the guidelines set out in the Cadbury and Smith Reports. However, the Guidance on Audit Committees (2016) recognises the fact that some companies may be too small to have a minimum of three independent non-executive directors to be appointed as members of the audit committee. In this respect, the Guidance on Audit Committees (2016) recommends that audit committees of smaller companies should be established with at least two members, all of whom should be independent non-executive directors.[770] The appointment of the audit committee must be made by the company's board of directors, on recommendation of the nomination committee, where applicable. Like the Cadbury Report (1992) and the Smith Report (2003), the Guidance on Audit Committees (2016) does not set out detailed guidelines for removal of members of the audit committee before expiration of their term of office.

4.2.2.4 The UK governance code (2018)

The UK Governance Code (2018) is a product of a consultative process by the FRC, aimed at revising and consolidating the previous codes.[771] Mallin notes that UK Governance Code (2018) is more focused than the previous versions and places more emphasis on the importance and values of corporate culture, building of trust and facilitation of meaningful engagements with stakeholders.[772] Instead of setting out rules which must be adhered to at all costs, the UK Governance Code (2018)

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[769] See Guidance on Audit Committees (2016) para 1.
[770] Guidance on Audit Committees (2016) para 9.
[771] A series of the UK governance codes started with the release of the Combine Code (1998), which was a product of the recommendations of the Cadbury Report (1992), the Greenbury Report (1995) and the Hampel Report (1998). The Combined Code (1998) was revised into the Combined Code (2003), the Combined Code (2006) and the Combined Code (2008). The entire Combined Code series was replaced by the UK Corporate Governance Code (2010), which was later revised into the UK Corporate Governance Code (2012), UK Corporate Governance Code (2014), UK Corporate Governance Code (2016) and the latest code, namely the UK Corporate Governance Code (2018). See Mallin AC *Corporate Governance* 6 ed (2018) 33-43.
[772] Mallin AC *Corporate Governance* 6 ed (2018) 43.

offers flexible corporate governance principles which should be applied through the application of the *'comply or explain'* rule.[773] As already pointed out, companies are required to comply with the governance code and where compliance is inappropriate or impossible, such non-compliance must be explained. The UK Governance Code (2018) sets out five key sections, namely, Board Leadership and Company Purpose; Division of Responsibilities; Composition, Succession and Evaluation; Audit, Risk and Internal Control; and Remuneration. For purposes of this study, this discussion is only confined to the relevant aspects of the Audit, Risk and Internal Control section of that code.

In terms of Principle M of the UK Governance Code (2018), boards of directors are required to ensure the independence and effectiveness of internal and external audit functions. This should be achieved by the establishment of formal and transparent policies and procedures which protect such independence and promote the effectiveness of the audit function.[774] For this reason, the UK Governance Code (2018) recommends the establishment of audit committees consisting of independent non-executive directors, with a minimum membership of three, or in the case of smaller companies, two.[775] It further recommends that the chairperson of the board of directors should not be a member of the company's audit committee.[776] Viewed as a whole, the audit committee should be competent for the relevant sector in which the company operates and at least one member of the committee should have financial experience.[777] The role and responsibilities of the audit committee are codified in paragraph 25 of the UK Governance Code (2018). Although not exhaustive, these roles and responsibilities include the duties of the audit committee outlined in the previous reports, particularly the Cadbury Report (1992), the Smith Report (2003) and the Guidance on Audit Committees (2016). These roles and responsibilities will not be repeated here in detail, save to point out that they are of an oversight nature.

[773] UK Governance Code (2018) 1.
[774] Principle M of the UK Governance Code (2018).
[775] See UK Governance Code (2018) para 24.
[776] UK Governance Code (2018) para 24.
[777] UK Governance Code (2018) para 24.

4.2.3 The protection of the independence of the audit committee in the UK

As it has been demonstrated in the exposition above, the various UK governance reports and codes do not make express provisions for the relevant process for appointment of members of the audit committee. Neither does the UK governance code, viewed in its entirety, set out the necessary procedure for removal of members of the audit committee before their end of term of office *qua* members of that committee.

The independence of audit committees under the UK system of corporate governance is contemplated in paragraph 24 of the UK Governance Code (2018). This reaffirmed the recommendations set out in paragraph 4.35(b) of the Cadbury Report (1992), paragraph 3.3.1 of the Smith Report (2003) and paragraph 9 of Guidance on Audit Committees (2016). These provisions recommend that audit committees should consist of independent non-executive members. The Cadbury Report (1992) defines a non-executive director as a director who brings an independent judgment to deliberations of the board of directors.[778]

The UK governance code appears to envision the audit committee as the subcommittee of the company's board of directors. It requires that the audit committee and its members be appointed by, be answerable and report to the board of directors.[779] Except the fact that members of the audit committee must be independent non-executive directors and must be appointed on recommendation by the nomination committee where applicable, there are no express mechanisms which safeguard the independence of individual members and the audit committee as a whole. The fact that the UK governance reports and codes have undergone a series of revisions and yet no attempt has been made to enhance the independence of the audit committee and its members is worrisome. It suggests that the UK legislators and corporate governance authors in that jurisdiction have not appreciated the possible interference with the independence of the audit committee and its function by the board of directors and management. Evidently, the drafters of the UK governance code seem have not identified the need for shareholders of

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[778] *Cadbury Report* (1992) para 4.12.

[779] *Cadbury Report* (1992) para 4.35(a); *Smith Report* (2003) para 3.3; Guidance on Audit Committees (2016) paras 9 and 29; UK Governance Code (2018) para 24.

the company to be involved in the appointment or removal of members of the audit committee.

The boards of directors of the UK companies are required to annually review the audit committee's effectiveness.[780] It is not clear what the board of directors may or may not do when it is not satisfied with the work or effectiveness of the audit committee. However, it is submitted that, by virtue of its power to appoint the audit committee and its members, the board of directors has the power to remove members of that committee. This may result in an undesirable situation where members of the audit committee who are perceived not to be bored-friendly being arbitrarily removed from the committee by the board of directors. Further, the UK governance framework requires the audit committee to create an environment for internal whistleblowing.[781] It is imaginable that allegations of possible improprieties in matters of financial reporting, financial control or any other matters may implicate members of the board of directors. As this may pit the audit committee against the board of directors, it is not clear how the audit committee is expected to address such matters. Nonetheless, this, it is submitted, calls for more mechanisms to safeguard the independence of the audit committee from both the board of directors and management.

To its credit, the UK governance code prohibits anyone, other than the chairperson of the audit committee and the committee members, to attend the meetings of the audit committee, unless otherwise invited by the committee.[782] In this respect, it is submitted that an attempt is made to protect the independence and integrity of the audit committee.

4.2.4 Comparative analysis – South Africa and the UK

It has been pointed out in the introductory segment above, that the South African corporate law has a strong UK heritage, and that the developments in English law have continued to inspire law reform in South Africa.[783] It therefore follows logically

[780] *Smith Report* (2003) para 4.3.
[781] *Smith Report* (2003) para 5.9.
[782] *Smith Report* (2003) para 3.6.
[783] Mupangavanhu notes that South Africa has followed developments in English company law and adopted corporate law principles as they were developed in the UK. The author even cites the

to undertake a comparison of the system of audit committees in South Africa with the one in the UK. This comparison is only confined to aspects which are relevant for determination of the independence of the audit committee, namely the composition of the audit committee, the appointment and removal of members of the committee. The purpose is to demonstrate how the independence of the audit committee of the UK companies is established and preserved, and whether South Africa could draw some lessons from that jurisdiction.

As a starting point, it must be highlighted that the South African provisions dealing with audit committees are embedded in both the Companies Act 2008 and the governance code, the *King IV Code*.[784] For the UK, the Companies Act 2006 does not set out any provisions for regulating the system of the audit committee in that jurisdiction. The UK audit committees are prescribed in terms of that country's corporate governance code. Like the South African *King IV Report* (2016) and its *King IV Code*, the UK governance code (2018) is a voluntary code. It employs the principle of comply or explain, which allows companies flexibility to comply with the code or set out reasons for non-compliance. The South African governance model has shifted from the 'apply or explain' principle. Instead, it uses the principle of 'apply and explain'.[785] For companies in South Africa, 'apply and explain' means that the corporate governance principles rooted in the *King IV Code* must not only be applied but also that it must be demonstrated that good governance is being practised.[786] Flowing from the aforesaid, it appears that the *King IV Report* (2016) does not contemplate compliance with the *King IV Code* as a mere tick-box exercise but rather, an exercise that serves proper corporate governance purpose.[787] While the UK Governance Code (2018) and the South African *King IV Code* are voluntary

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DTI Policy Document 2004 which acknowledges that company law in South Africa including the Companies Act 61 of 1973 was 'based on the framework and general principles of the English law', see Mupangavanhu BM *Directors' Standards of Care, Skill, Diligence and the Business Judgment Rule in View of South Africa's Companies Act 71 of 2008:Future Implications for Corporate Governance* (published PhD thesis, University of Cape Town, 2016) at 70, citing the 'Foreword' from then Minister of Trade and Industry Mandisi Mpahlwa to the paper that initiated law reform resulting in the Companies Act 71 of 2008. That paper was titled *South African Company Law for the 21st Century: Guidelines for Corporate Law Reform* (the DTI Policy Document) GN 1183 in *GG* 2004-06-23.

[784] The *King IV Code* is embedded in the *King IV Report* (2016).

[785] See the Foreword to the *King IV Report* (2016) at 7 and for more details on the 'Apply principles' and the 'Explain practices'; Also see the *King IV Report* (2016) at 37

[786] See *King IV Report* (2016) 7.

[787] See *King IV Report* (2016) at 22, where the objectives of the report are stated.

codes, they both serve as strict listing rules and requirements in the countries' respective Stock Exchanges.[788]

An exposition of the protection of audit committee in the UK has been provided above and will not be repeated here. Suffice it to highlight the fact that the shareholders of the UK companies do not play any role in the establishment of audit committees and appointment of members thereto. In that jurisdiction, the appointment and, by necessary implication, removal of members of the audit committee is the responsibility of the board of directors, on recommendation by the nomination committee. It is not clear what should happen in instances where the board of directors does not accept the recommendations of the nomination committee. In contrast, audit committees of the South African companies enjoy a greater measure of protection than their UK counterparts. In South Africa, the establishment of the audit committee and appointment of its members is regulated in terms of legislation,[789] and not merely regulated by means of a voluntary governance code. The provisions of section 94(2) of the Companies Act 2008 prescribe that companies which are required in terms of the Act to appoint an audit committee must do so at an annual general meeting. It must be noted that the annual general meeting contemplated in section 94 of the Companies Act 2008 is the meeting of the company's shareholders.[790]

The Companies Act 2008 does not explicitly prescribe that the members of the audit committee must be independent non-executive directors of the company. Neither does the Companies Act 2008 provide an express definition of the term non-executive director. However, the requirement for members of the audit committee to be non-executive directors is implied in section 94(4) of the Companies Act 2008. On the other hand, the UK Governance Code (2018) clearly specifies that members of the audit committee must be independent non-executive directors.[791] In this

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[788] See UK Governance Code (2018) 3 and JSE Limited Listings Requirements para 3.84 available at https://www.jse.co.za/sites/default/files/media/documents/2019-04/JSE%20Listings%20Requirements.pdf (accessed on 06 May 2021).

[789] For companies which are required to establish audit committees, they must do so in terms of section 94(2) of the Companies Act 2008.

[790] See s 1 for a definition of an 'annual general meeting' and s61(7), read with subsection (8)(a)(iii) of the Companies Act 2008. Also see Delport P *New Entrepreneurial Law* 2 ed (2021) 123; Cassim et al *Contemporary Company Law* 3 ed (2021) 496.

[791] UK Governance Code (2018) para 24.

respect, both in the UK[792] and South Africa,[793] only directors of the company who are not involved in the day-to-day management of the company and have no relationship with the company other than as directors may be appointed on the company's audit committee.

Both the UK and South African corporate governance models do not make express provisions for the removal of members of the audit committee before expiration of their term of office. This lacuna in both the UK and South Africa makes it possible for the board of directors to arbitrarily remove members of the audit committee who may be perceived to be not board friendly. It is submitted that the audit committee that performs its duties with some degree of fear or favour towards the board of directors is a threat to its own effectiveness, sound corporate governance, integrity of financial reporting and controls assurance.

4.3 CORPORATE GOVERNANCE & THE AUDIT COMMITTEE IN THE USA

4.3.1 The audit committee in the USA: Brief historical synopsis

Like the UK, the USA jurisdiction has suffered a number of corporate governance challenges for many years. While the highly publicised Enron and WorldCom corporate catastrophes have exposed weaknesses in the USA corporate governance model, financial and auditing systems, it was the corporate scandals in the case of McKesson & Robbins Incorporated which resulted in the recommendation for establishment of audit committees in the 1930s.[794] The scandals of McKesson & Robbins Incorporated are best described by Shinde *et al*[795] as 'impactful' on the auditing standards. In other words, these scandals necessitated a different perspective and approach to the auditing practice. After an intensive

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[792] UK Governance Code (2018) para 24. Also see Waddell J 'The role of the non-executive director' *Stevens & Bolton*, available on https://www.stevens-bolton.com/cms/document/A_briefing_on_the_role_of_the_non_executive_director.pdf (accessed on 26 May 2022). In the article, the author explains the role of the non-executive directors of the UK companies as being typically supervisory and that non-executive directors in that jurisdiction are not expected to be actively involved in the day-to-day management of the company.

[793] S 94(4)(a), read with subsection (4)(b)(i) of the Companies Act 2008.

[794] See Marx B (2008) 121-122.

[795] Shinde et al 'Establishment of GAAS: Impact of an Auditing Fraud' (2015) 15(1) *Journal of Accounting and Finance* 40.

investigation of the McKesson & Robbins Incorporated corporate scandal, the Securities and Exchange Commission ('SEC') recommended the

> Establishment of a committee to be selected from non-officer members of the board of directors which shall make all company or management nominations of auditors and shall be charged with the duty of arranging the details of the engagement.[796]

The aftermath of McKesson & Robbins Incorporated catastrophes and the resultant SEC recommendations is that audit committees became a listing requirement for listed companies in the USA.[797] In its effort to impose higher levels of responsibility on the audit committees, the SEC, working with the New York Stock Exchange ('NYSE') and National Association of Securities Dealers Automated Quotations ('NASDAQ'), established a committee called the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit committees ('BRC') in 1998.[798] The BRC was tasked with the responsibility to investigate and recommend mechanisms which could strengthen audit committees in respect of their role to oversee the financial reporting process.[799]

4.3.2 Legislative & governance framework for the audit committee in the USA

4.3.2.1 The Blue Ribbon Committee Report

The BRC released its report called 'Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees' in February 1999 ('the BRC Report (1999)').[800] For the purpose of improvement of the financial reporting oversight role of the audit committee, the BRC Report (1999) made a number of recommendations regarding the composition and functions of the

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[796] See United States. Securities and Exchange Commission, 'In the matter of McKesson & Robbins, Inc., File No. 1-1435: Securities Exchange Act of 1934, Section 21 (a); Summary of findings and conclusions' (1940) Federal Publications 107 available at https://egrove.olemiss.edu/acct_fed/107 (accessed on 27 April 2021).

[797] Lutzy JM 'Analysis of the Proposed NYSE Corporate Governance and Audit Committee Listing Requirements' (2003) 2 (1) *DePaul Business and Commercial Law Journal* 99-100; Also see Marx B (2008) 122.

[798] Abbott JL, Parker S and Peters FG 'The Effectiveness of Blue Ribbon Committee Recommendations in Mitigating Financial Misstatements: An Empirical Study', Working Paper (Draft 1.1, November 2000), *Santa Clara University* 1.

[799] Marx B (2008) 134.

[800] Smith LM 'Audit committee effectiveness: did the blue ribbon committee recommendations make a difference?' (2006) 3(2) *Int. J. Accounting, Auditing and Performance Evaluation* 240.

audit committee.[801] Consequently, the SEC amended its rules, and both the NYSE and NASDAQ amended their listing requirements.[802] While the BRC recommendations were not mandatory and only applicable to listed companies of over a specific size, the BRC encouraged all companies, regardless of their size, to make an attempt to implement its recommendations.[803]

Among others, the BRC Report (1999) made a recommendation for audit committees of the USA listed companies to entirely comprise of independent directors.[804] The BRC Report (1999) asserts the purpose of this recommendation as to strengthen the independence of the audit committee as a whole. For the purpose of independence of the audit committee, the BRC Report (1999) considers members of the audit committee to be independent if they have no relationship with the company and its management, which relationship may interfere with the members' exercise of independence when executing their duties as members of the audit committee.[805] In this regard, BRC Report (1999) lists a few examples of relationships which may compromise the independence of a member of the audit committee.[806] However, BRC Report (1999) also recognises the fact that it may be necessary, under exceptional and limited circumstances, for the board of directors to appoint a director who has a relationship with the company, provided that it is shown that such appointment is in the best interests of the company.[807] In such circumstances, the board of directors is required to disclose the nature of the relationship and the determination that the appointment is in the best interests of the

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[801] Smith LM 'Audit committee effectiveness: did the blue ribbon committee recommendations make a difference?' (2006) 3(2) *Int. J. Accounting, Auditing and Performance Evaluation* 243.
[802] Marx B (2008) 137.
[803] BRC 'Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees' (1999) 54 *The Business Lawyer* 1071.
[804] BRC 'Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees' (1999) 54 *The Business Lawyer* 1073.
[805] See BRC 'Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees'(1999) 54 *The Business Lawyer* 1072; Also see Braiotta JR et al *The Audit Committee Handbook* 5 ed (2010) *John Wiley & Sons Inc* 17; Also see Marx B (2008) 135.
[806] See BRC 'Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees' (1999) 54 *The Business Lawyer* 1072.
[807] BRC 'Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees' (1999) 54 *The Business Lawyer* 1073.

company.[808] It is clear from the language the BRC Report (1999) that it adopted an attitude that independence is the key foundation of the audit committee.

Recommendation 3 of the BRC Report (1999) makes provision for the audit committee to consist of a minimum of three independent directors.[809] The purpose of this recommendation is not necessarily to enhance the independence of the audit committee but rather to improve its effectiveness. Disappointingly, the BRC Report (1999), like the Cadbury Report (1992) and the subsequent governance codes in the UK, does not make any provisions for the removal of members of the audit committee from the committee before expiration of their term of office. Neither is it clear from the text of the BRC Report (1999) as to who is responsible for the nomination, election or appointment of members of the audit committee. However, the BRC Report (1999) noted that for a proper and well-functioning oversight and monitoring system to exist, there must be a 'three-legged stool' consisting of the full board of directors *including the audit committee*, the financial management including the internal auditor and the external auditor, which supports responsible financial disclosure and participatory oversight.[810] Flowing from the aforementioned, it appears that the BRC Report (1999) had imagined the audit committee as a committee of the board of directors. Therefore, it may be assumed that the BRC Report (1999) envisioned the appointment and removal of members of the audit committee to be made by the board of directors. This is further apparent from the BRC's observation that 'if a board is functioning properly, the audit committee can build on and relate to these very same board-wide principles. If the board is dysfunctional, the audit committee likely will not be much better'.[811] In other words, a failing board of directors is failing audit committee.

The BRC expressed the view that the implementation of the BRC Report (1999) recommendations could help improve the effectiveness of the audit committee and

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[808] BRC 'Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees' (1999) 54 *The Business Lawyer* 1073.
[809] BRC 'Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees' (1999) 54 *The Business Lawyer* 1073.
[810] BRC 'Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees' (1999) 54 *The Business Lawyer* 1071.
[811] BRC 'Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees' (1999) 54 *The Business Lawyer* 1070.

maintain investors' confidence.[812] It required that the individual members of the audit committee must not only be independent but also possess certain individual characteristics, integrity and a sense of accountability.[813] Marx asserts that the BRC Report (1999) was a very important milestone in the USA.[814] However, major corporate and financial reporting scandals continued, notably the Enron and WorldCom disasters of the early 2000s. This resulted in promulgation of SOX in 2002.[815]

In brief, the Enron and WorldCom accounting scandals are as follows: Founded in the late 1900s, Enron was one of the largest corporations in the USA.[816] When the company experienced financial difficulties in 1997, its directors employed a variety of deceptive, bewildering, and fraudulent accounting practices and tactics to cover its fraud in reporting the Enron's financial information, instead of admitting to the financial challenges the company had been faced with.[817] In the late 2000, the company reported an apparent healthy profit,[818] which was signed off by the company's auditor, Arthur Andersen,[819] one of the big four accounting and audit firms at the time. However, only a year later and in the late 2001, Enron filed for bankruptcy.[820] In 2006, some of the company's former directors were convicted and imprisoned. WorldCom suffered a similar fate. WorldCom was a large telecommunication company in the USA.[821] After some brave acts of whistleblowing, the SEC instituted investigations, which found the company to have overstated its

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[812] BRC 'Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees' (1999) 54 *The Business Lawyer* 1077.
[813] BRC 'Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees' (1999) 54 *The Business Lawyer* 1078.
[814] Marx B (2008) 137.
[815] Smith LM 'Audit committee effectiveness: did the blue ribbon committee recommendations make a difference?' (2006) 3(2) *Int. J. Accounting, Auditing and Performance Evaluation* 241.
[816] Ramadhani DA 'The Enron Scandal - A Simple Overview' (2020), available on https://www.researchgate.net/publication/350107341_THE_ENRON_SCANDAL_-_A_Simple_Overview (accessed on 26 May 2022).
[817] Ramadhani DA (2020).
[818] Mallin AC *Corporate Governance* 6 ed (2018) 2.
[819] Moncarz ES et al 'The Rise and Collapse of Enron: Financial Innovation, Errors and Lessons' (2006) vol 218 *Contaduría y Administración* 24. The auditor, Arthur Andersen, signed off the Enron financials despite the company's questionable accounting practices.
[820] Mallin AC *Corporate Governance* 6 ed (2018) 3.
[821] See George B 'Fraudulent Accounting and the Downfall of WorldCom' (2021) available on https://www.sc.edu/about/offices_and_divisions/audit_and_advisory_services/about/news/2021/worldcom_scandal.php (accessed on 26 May 2022).

assets.[822] This happened despite the fact that WorldCom had the audit committee consisting of four members in line with the recommendations of the BRC Report (1999).[823] In the end, the company filed for bankruptcy and some of its directors were charged for fraud, conspiracy, and filing false documents with regulators.[824]

4.3.2.2 Sarbanes Oxley Act (2002)

An empirical study by Smith[825] found that the implementation of the BRC recommendations has improved audit committee effectiveness in the USA. However, following the persistent corporate governance and financial reporting challenges in the USA and despite the recommendations of the BRC, the US Congress agreed to a reform, which resulted in the promulgation of the Public Company Accounting Reform and Investor Protection Act in July 2002. This Act became known as Sarbanes Oxley Act 2002.[826] The SOX Act seeks to protect investors by improving the accuracy and reliability of corporate disclosures.[827] Mallin suggests that the SOX Act also seeks to enhance the independence of the external auditors and the audit committee.[828] It is said that the SOX Act has wide reaching implications, not only for USA companies but also for foreign companies listed in the USA.[829] It requires the SEC to adopt rules which compel the NYSE and NASDAQ to prohibit the listing of a company's securities unless that company has the audit committee entirely consisting of independent directors and that audit committee meets certain requirements for its responsibility and operation.[830]

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[822] George B (2021); Also see Fairchild R, Gwilliam D & Marnet O 'Audit Within the Corporate Governance Paradigm: A Cornerstone Built on Shifting Sand?' (2019) vol 30 *British Journal of Management* 93.

[823] Fairchild R, Gwilliam D & Marnet O 'Audit Within the Corporate Governance Paradigm: A Cornerstone Built on Shifting Sand?' (2019) vol 30 *British Journal of Management* 94.

[824] George B (2021).

[825] Smith LM 'Audit committee effectiveness: did the blue ribbon committee recommendations make a difference?' (2006) 3(2) *Int. J. Accounting, Auditing and Performance Evaluation* 249-250.

[826] See Marx B (2008:139); Mallin AC *Corporate Governance* 6 ed (2018) 62.

[827] See the short preamble appearing just under the text 'An Act' before the Short Title and Table of Contents in the Sarbanes Oxley Act of 2002.

[828] Mallin AC *Corporate Governance* 6 ed (2018) 62.

[829] Hendrikse JW & Hefer L *Corporate Governance Handbook: Principle and Practice* 3 ed (2019) 113.

[830] Hendrikse JW & Hefer L *Corporate Governance Handbook: Principle and Practice* 3 ed (2019) 114; See s 301 of Sarbanes Oxley Act of 2002 and s 10A(m) of Securities Exchange Act of 1934.

The SOX Act provides a clear definition of the term audit committee. Section 2(3) of the SOX Act defines audit committee as

> a committee or equivalent body established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer and if no such committee exists with respect to an issuer, the entire board of directors of the issuer.

Section 205(a) of the SOX Act amended section 58 of the Securities Exchange Act of 1934 which includes the definition of the audit committee. What is apparent from this definition is that the audit committee is a committee of the board of directors under the SOX Act and Securities Exchange Act of 1934. This is further confirmed by the provisions of section 301 of the SOX Act and section 10A(m) of Securities Exchange Act of 1934. It is a committee of, appointed by and answerable to the board of directors of the company.[831]

The SOX Act makes an effort to inspire corporate responsibility. In this regard and for the purpose of the independence of the audit committee, the SOX Act prescribes that each member of the audit committee must be a member of the company's board of directors and must be independent.[832] In determining such independence, the SOX Act provides that a member may not accept any consulting, advisory, or other compensatory fee from the company or be an affiliated person of the company or any of its subsidiaries, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee.[833] However, the SOX Act empowers the SEC to exempt a particular relationship with respect to audit committee members, as it deems appropriate in light of the circumstances.[834]

Surprisingly, neither the SOX Act nor the Securities Exchange Act of 1934 makes any express statement about the required minimum number of members of the audit committee. The SOX Act only requires that at least one member of the audit

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[831] See Johnson L.P.Q. 'The Audit Committee's Ethical and Legal Responsibilities: The State Law Perspective'(2005) 47(27) *South Texas Law Review* 30.
[832] S 301(3)(A) of Sarbanes Oxley Act of 2002.
[833] S 301(3)(B) of Sarbanes Oxley Act of 2002.
[834] S 301(3)(C) of Sarbanes Oxley Act of 2002.

committee must be a financial expert.[835] It appears that the determination of the size of the audit committee is left to the discretion of the board of directors.[836] Further, it is not expressly stated as to which body is responsible for the appointment and removal of members of the audit committee under the SOX Act. However, it has been established in the preceding discussion, that the SOX Act imagines the audit committee as a committee of, appointed by and accountable to the board of directors.[837]

4.3.3 Protection of the independence of the audit committee in the USA

The evaluation of the legislative and governance framework governing the USA audit committees shows that independence is the flagship of the system of audit committee in that jurisdiction. Specifically, the BRC Report (1999) makes two recommendations which are explicitly aimed at establishing independence within the scheme of the audit committees. The purpose is to strengthen the audit committee. BRC Report (1999) does not only recommend that, viewed in its entirety, the audit committee must consist of only independent directors, but also provides clear guidelines to determine the independence of such directors. The recommendations of the BRC Report (1999) dealing with the audit committee independence have been legislated under the SOX Act. In this regard, it is submitted that the consequences of legislated requirements for the independence of audit committees in the USA is that such independence is not just a recommendation which may or may not be followed, but a mandatory requirement for certain companies in that country. The reason for this is that the SOX Act is a legislation 'enacted by the Senate and House of Representatives of the United States of America in Congress'[838] and not a voluntary code.

[835] S4 07(a) of Sarbanes Oxley Act of 2002.
[836] See Johnson L.P.Q. 'The Audit Committee's Ethical and Legal Responsibilities: The State Law Perspective'(2005) 47(27) *South Texas Law Review* 31.
[837] See the definition of the audit committee in s 2(3) of Sarbanes Oxley Act of 2002. Also see s 301 of Sarbanes Oxley Act of 2002 and s 10A(m) of Securities Exchange Act of 1934. Also see Johnson L.P.Q. 'The Audit Committee's Ethical and Legal Responsibilities: The State Law Perspective'(2005) 47(27) *South Texas Law Review* 30.
[838] See the short paragraph appearing just before the Short Title and Table of Contents in the Sarbanes Oxley Act of 2002.

It has been demonstrated above, that the USA legislative and corporate governance framework characterises the audit committee as the committee of the company's board of directors.[839] This does very little to protect the independence of the committee. As the BRC observed, if the board is dysfunctional, the audit committee will likely not be much better.[840] For this reason, the audit committee should enjoy a greater measure of independence and protection from the board of directors. This is to ensure that, despite the board's governance challenges, the audit committee should continue to provide the necessary financial reporting, audit and compliance oversight for the benefit of stakeholders. It is submitted that a board-dependent or attached audit committee does very little to allay the agency costs theory fears for stakeholders in general and shareholders in particular.[841]

A further weakness in the independence of the audit committee and protection of such independence under the USA corporate governance model may be the requirement that members of the audit committee should be appointed by the board of directors. By necessary implication, the board of directors has the powers to remove members from the audit committee at any time the board deems it fit. The difficulty may arise when the board of directors exercises its power to arbitrarily remove members of the audit committee in instances where there are conflicts or disagreements between the board and the committee. The USA corporate governance model does not provide an express procedure for the removal of members of the audit committee before their end of term of office. This makes it possible for victimisation, purging and capricious removal of members from the audit committee by the company's board of directors. As canvassed above,[842] a pro-board

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[839] See s 301 of Sarbanes Oxley Act of 2002; Also see s 10A(m) of Securities Exchange Act of 1934.
[840] BRC 'Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees' (1999) 54 *The Business Lawyer* 1070.
[841] See the discussion in 2.2.4.1 above. For detailed discussion on the agency theory, see Akwenye NJ, Chata T & Benedict OH 'Establishment of audit committee in government ministries of a developing country' (2016) 6(4) *Risk Governance & Control: Financial Markets & Institutions* 283; Thabane T & Snyman-Van Deventer E 'Pathological Corporate Governance Deficiencies in South Africa's State-Owned Companies: A Critical Reflection' (2018) 21 *PER /PELJ* 6-8; Chokuda CT *The Protection of Shareholders' Rights versus Flexibility in the Management of Companies: A Critical Analysis of the Implications of Corporate Law Reform on Corporate Governance in South Africa with specific reference to protection of shareholders* (published PhD thesis, University of Cape Town, 2017) 80-81; Zábojníková G *The Audit Committee Characteristics and Firm Performance: Evidence from the UK* (Masters in Finance dissertation, Porto University, 2016) 3. Mupangavanhu BM (2016) 50.
[842] See point 4.2.4 in Chapter 4 of this thesis.

audit committee is a threat to its own effectiveness, good corporate governance, integrity of financial reporting and controls assurance.

4.3.4 Comparative analysis – South Africa and the USA

The South African audit committees appear to enjoy better protection than audit committees in the USA. In South Africa, the Companies Act 2008 gives the shareholders the power to elect and appoint members of the audit committee at the annual general meeting.[843] The board of directors is permitted to appoint members of the audit committee only in two instances, namely (i) to set up the first audit committee of the company and appoint its first members after the incorporation of the company[844] and (ii) to fill any vacancies on the existing audit committee before the next shareholders' annual general meeting.[845] By contrast, the audit committees in the USA are only appointed by the board of directors. Further, the USA legislative and corporate governance framework does not regulate when the board of directors may appoint members of the audit committee. In this respect, it appears therefore that audit committee members may be appointed at any time the board of directors sees it appropriate. It is submitted that this gives the board of directors the latitude to remove members they dislike and appoint their allies to the audit committee.

The USA audit committees are subcommittees of the companies' boards of directors. This is set out in express terms in section 301 of Sarbanes Oxley Act of 2002 and section 10A(m) of Securities Exchange Act of 1934. Consequently, the USA audit committees operate under full control of the board of directors in that country. They report and account to the board of directors. In comparison, the South African audit committees cannot possibly be subcommittees of the boards of directors as demonstrated in point 2.3.1 in Chapter 2 of this thesis. Conceivably, an audit committee under the Companies Act 2008 is a standalone committee of the company, appointed by and accountable to the shareholders in a meeting. It is submitted that the independence of the committee that is appointed by and

[843] S 94(2) of the Companies Act 2008.
[844] S 94(3)(b) of the Companies Act 2008.
[845] S 94(6) of the Companies Act 2008.

accountable to the shareholders enjoys better protection from interference than that of the committee appointed by and accountable to the board of directors.

There are some similarities between audit committees in the USA and South Africa. In both countries, audit committees are required to be staffed with non-executive directors who have no relationship with the company than *qua* non-executive directors. In this regard, the only difference is that South African audit committees are legislatively required to consist of at least three members.[846] There is no similar legislative requirement in the USA. The minimum number of members of the audit committee in the USA is only recommended in terms of the BRC Report (1999).[847] A further distinction is that the independence of the audit committee in the USA is expressly legislated[848] in that country. In South Africa, there is no express statement in respect of the independence of the audit committee under the Companies Act 2008 or its regulations. The independence of the audit committee under the Companies Act 2008 has only been set out in implicit terms in section 94(4)*(b)* and *(c)* of that Act.

4.4 CONCLUSION

In this chapter, it has been shown that independence underpins the audit committee as a corporate governance mechanism, globally. In particular, independence has become an essential feature of audit committees in jurisdictions with large economies such as the UK and USA. As pointed out, the UK Companies Act 2006 does not set out any provisions dealing with audit committees in that jurisdiction.[849] The relevant provisions governing audit committees in the UK are only contained in a governance code, which forms part of the rich corporate governance framework in that country.[850] By contrast, the South African audit committees are regulated

[846] S 94(2) of the Companies Act 2008.
[847] BRC 'Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees' (1999) 54 *The Business Lawyer* 1073.
[848] In terms of the s 301 of Sarbanes Oxley Act of 2002 and s 10A(m) of Securities Exchange Act of 1934.
[849] See point 4.2.4 in Chapter 4 of this thesis.
[850] See the discussion of various UK governance codes in point 4.2.2 in Chapter 4 of this thesis.

through legislation under the Companies Act 2008.[851] Similarly, the American audit committees are legislated in terms of the SOX Act in that jurisdiction.[852]

The UK governance code requires audit committees to be staffed with non-executive directors. This position is the same in South Africa and the USA. This appears to be an attempt to establish independence within the audit committee. However, the UK and the USA governance codes and legislation do not provide enough mechanisms to safeguard such independence in those jurisdictions. Both the UK[853] and the USA[854] legislative and governance frameworks envisage the audit committee as a committee of, appointed by and accountable to the board of directors. This exposes the audit committee to undue influence which may erode its independence. In South Africa, audit committees appear to enjoy a better protection under the Companies Act 2008, through the involvement of the company's shareholders in the appointment of members of the audit committee.[855]

While it has been demonstrated that the independence of the South African audit committees enjoys a better protection than the independence of audit committees in the UK and the USA, it is not to suggest that such independence is adequately protected in South African law. The next chapter critically evaluates the independence of the audit committees under South African business framework in both private and public entities, with reference to the Companies Act 2008 and the PFMA. It will be demonstrated that the independence is not adequately protected from possible interference and undue influence by the corporations' board of directors and accounting authorities.

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[851] See s 94 of the Companies Act 2008.

[852] In terms of the s 301 of Sarbanes Oxley Act of 2002 and s 10A(m) of Securities Exchange Act of 1934.

[853] See the discussion in point 4.2.2 in Chapter 4 of this thesis.

[854] See the discussion in point 4.3.2 in Chapter 4 of this thesis.

[855] See the discussion in points 4.2.4 and 4.3.4 in Chapter 4 of this thesis, where the comparison of the UK and the USA on the one hand and South Africa on the other was undertaken. The provisions of s 61(8)(a)(iii) and s 94(2) of the Companies Act empowers the shareholders to appoint members of the company's audit committee.

CHAPTER 5: THE EVALUATION OF THE INDEPENDENCE OF THE AUDIT COMMITTEE AND THE PROTECTION THEREOF

5.1 INTRODUCTION

The discussions in this thesis have hitherto centered on the theme of the independence of the audit committee, with specific focus on the lack of adequate mechanisms to safeguard such independence. The purpose of this chapter of the study is to critically examine the relevant provisions of the Companies Act 2008 and the PFMA relating to the audit committee and to demonstrate that the relevant provisions of these statutes do not provide adequate safeguard of the audit committee's independence. Accordingly, Chapter 5 begins with a comprehensive analysis of the meaning of the term 'independence' within the context of an independent body or institution or organisation, whose primary role is to provide oversight on an individual or group, on behalf of or for the benefit of others. The objective is to contextualise the term 'independence' as it is interpreted and applied in this chapter and everywhere else in this study.

Chapter 5 further provides an in-depth evaluation of the various provisions of the Companies Act 2008 and the PFMA which establish the independence of the company's audit committee. From this exposition, it will become clear as to whether these provisions provide adequate protection of the independence of the audit committee or require the necessary legislative intervention. The discussion in this chapter will also provide detailed analysis of the provisions of the Companies Act 2008 and the PFMA in so far as they may expose the audit committee to possible interference with its independence. As propounded throughout the preceding chapters, this intrusion of the independence of the audit committee is expected to emanate from those who are entrusted with the management of the business and affairs of the company, namely the board of directors.[856] Part of the purpose of this chapter is to illustrate that the role and functions of the audit committee as discussed in the previous chapter, require an audit committee whose independence is

[856] S 66(1) of the Companies Act 2008 is authority for the assertion that the business and affairs of the company must be managed under the board's leadership and oversight.

adequately protected. It is argued in this regard that such protection is lacking under the Companies Act 2008 and the PFMA.

5.2 THE MEANING OF THE TERM 'INDEPENDENCE' WITHIN THE CONTEXT OF THE AUDIT COMMITTEE

Although the terms 'independent', 'independence' and 'independently' collectively appear no less than sixty times in it, the Companies Act 2008 does not provide an express definition of these terms for the Act's interpretational purposes. Therefore, it is necessary to fashion out a proper definition of the term 'independence' in the context of the independence of the company's audit committee, with the aid of corporate law reports, governance codes, literature and judicial precedents.

Colloquially, the term independence may be defined as state of being independent.[857] It is a state of not being subject of control or authority by others.[858] However, when viewed with the lens of corporate governance, independence means the exercise of an objective, unfettered judgment.[859] It refers to the general acceptance that there is no existence of relationships or circumstances which might affect the director's judgment.[860] When used specifically in reference to non-executive members of the company's board of directors and its committees, independence refers to the absence of interest, position, association or relationship which, when viewed from the perspective of a reasonable and informed third party, is likely to cause undue influence or bias in the decision-making of that member.[861] Therefore, independence comprises both independence of mind and independence in appearance.[862] In this regard, the Constitutional Court in *Glenister v President of RSA and Others*[863] reaffirmed the court's finding in *S v Van Rooyen*[864] that the appearance or perception of independence plays an important role in evaluating

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[857] Definition available at https://www.merriam-webster.com/dictionary/independence (accessed on 23 January 2021).
[858] See definition of the term independent available at https://www.merriam-webster.com/dictionary/independent (accessed on 23 January 2021).
[859] *King IV Report* (2016) 13.
[860] Mallin AC *Corporate Governance* 6 ed (2018) 215.
[861] *King IV Report* (2016) 13.
[862] Delport P *Henochsberg's Commentary on the Companies Act 71 of 2008* (2017) 360.
[863] (CCT 48/10) [2011] ZACC 6; 2011 (3) SA 347 (CC); 2011 (7) BCLR 651 (CC) (17 March 2011).
[864] *S v Van Rooyen and Others* (CCT21/01) [2002] ZACC 8; 2002 (5) SA 246; 2002 (8) BCLR 810 (11 June 2002) para 32.

whether independence in fact exists.[865] An independent individual, an independent entity, an independent organisation or an independent committee within an organisation will have the requisite independence if it can be established that the reasonably informed member of the public will have confidence in that individual's or committee's or the entity's autonomy-protecting features.[866] Accordingly, a body cannot be said to be independent if it lacks features that protect such independence.

In a unanimous judgment, the Constitutional Court in *Corruption Watch NPC and Others v President of the Republic of South Africa and Others* held that:

> amongst the factors that are relevant to the independence of offices or institutions which, in terms of constitutional prescripts, must be independent are the method of appointment, the method of reporting, disciplinary proceedings and the method of removal…from office, and security of tenure.[867]

It is submitted that this may be extrapolated to individuals who are required to be independent under any other law, such as independent members of the audit committee under the Companies Act 2008 and the PFMA. The independence of individuals or committees which are required to be independent under any law also depends pivotally on the independence of those who appointed them.[868] For example, the independence of the registered auditor of a company depends, to some degree, on the independence of the audit committee[869] and the independence of the audit committee depends on the independence of those who have staffed it.

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[865] *Glenister v President of the Republic of South Africa and Others* (CCT 48/10) [2011] ZACC 6; 2011 (3) SA 347 (CC); 2011 (7) BCLR 651 (CC) (17 March 2011) para 207. Also see *Helen Suzman Foundation v President of the RSA and Others*; *Glenister v President of the RSA and Others* (CCT 0714, CCT 0914) [2014] ZACC 32 2015 (1) BCLR 1 (CC) 2015 (2) SA 1 (CC) (27] para 31; *McBride v Minister of Police and Another* (CCT255/15) [2016] ZACC 30; 2016 (2) SACR 585 (CC); 2016 (11) BCLR 1398 (CC) (6 September 2016) para 42.

[866] *McBride v Minister of Police and Another* (CCT255/15) [2016] ZACC 30; 2016 (2) SACR 585 (CC); 2016 (11) BCLR 1398 (CC) (6 September 2016) para 37.

[867] *Corruption Watch NPC and Others v President of the Republic of South Africa and Others; Nxasana v Corruption Watch NPC and Others* (CCT 333/17; CCT 13/18) [2018] ZACC 23; 2018 (10) BCLR 1179 (CC); 2018 (2) SACR 442 (CC) (13 August 2018) para 22. Also see *McBride v Minister of Police and Another* (CCT255/15) [2016] ZACC 30; 2016 (2) SACR 585 (CC); 2016 (11) BCLR 1398 (CC) (6 September 2016) para 31.

[868] *Helen Suzman Foundation v President of the RSA and Others*; *Glenister v President of the RSA and Others* (CCT 0714, CCT 0914) [2014] ZACC 32 2015 (1) BCLR 1 (CC) 2015 (2) SA 1 (CC) (27] para 153.

[869] S 94(7)(a) of the Companies Act 2008 imposes the duty on the audit committee to nominate an independent auditor for appointment by the company in term of s 90 of the Companies Act 2008. For SOEs, Regulation 27.1.8(f) of Treasury Regulations for PFMA further imposes the duty on

From the foregoing, the term independence must be understood to mean the exercise of judgment without undue influence. Subjectively, independence means 'the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity, and exercise objectivity and professional scepticism'.[870] Objectively, it refers to avoidance of facts and circumstances that may lead a reasonable and informed third party to likely conclude, considering all the specific facts and circumstances, that the integrity, objectivity or professional scepticism of an individual has been compromised.[871] Like company liquidators and business rescue practitioners, who are required to be independent, independence as it relates to individual members of the company's audit committee requires the members to not have any direct or indirect relationship with the company, its management or any person concerned with the business and affairs of the company, which may place them in a position of conflict of interest or prevent them from exercising an independent judgment on the matters relating to the audit committee.[872]

The independence of individual members of the company's audit committee is rooted in section 94(4)*(b)* and *(c)* of the Companies Act 2008. This section implies that a director contemplated in section 94(4)*(a)* must not be an executive director or must not have so been, at any period during the company's previous financial year,[873] and must not be related to any person prohibited in terms of subsection (4)(b).[874] Accordingly, a member of the audit committee must be a non-executive

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the audit committee (which itself must be constituted so as to ensure its independence, see Regulation 3.1.5 of Treasury Regulations for PFMA) to ensure the independence and objectivity of the external auditors. Also see Ghafran C & O'Sullivan N 'The Governance Role of Audit Committees: Reviewing a Decade of Evidence' (2012) *International Journal of Management Reviews* at 9, where it is stated that 'audit committees are responsible for safeguarding auditor independence and are therefore expected to be directly involved in the decisions taken regarding the provision of non- audit services'.

[870] See Independent Regulatory Board for Auditors 'New Rules Regarding Improper Conduct and Code of Professional Conduct for Registered Auditors' BN 89, G. 33305 (c.i.o 1 January 2011) para 290.6.

[871] See Independent Regulatory Board for Auditors 'New Rules Regarding Improper Conduct and Code of Professional Conduct for Registered Auditors' BN 89, G. 33305 (c.i.o 1 January 2011) para 290.6.

[872] *Knoop and Another NNO v Gupta (Tayob Intervening)* (116/2020) [2020] ZASCA 163 (9 December 2020) para 24.

[873] S 94(4)(b)(i) of the Companies Act 2008.

[874] S 94(4)(c) of the Companies Act 2008.

director who is in a position to bring an independent mind and an unfettered judgment to the audit committee.

5.3 The protection of the independence of the audit committee under the Companies Act 2008

5.3.1 Provisions which strengthen the independence of the audit committee and protection thereof

5.3.1.1 Audit committee as an organ of the company

The question as to whether the audit committee is a subcommittee of the board of directors or a standalone organ of the company was discussed in Chapter 2[875] and will not be repeated in this segment. Among other key findings, Chapter 2 has established that the audit committee is a standalone organ of the company.[876] The purpose of this discussion is to illustrate that the correct characterisation of the audit committee as organ of the company has the effect of solidifying the independence of that committee and protection thereof.

While the independence and integrity of the individual members of the company's audit committee are paramount, the characterisation of the audit committee as a committee of the board of directors or as a standalone organ of the company is equally important. The protection of the independence of the audit committee as a whole depends, to some degree, on the determination as to who the committee is appointed by and accountable to. It is submitted that the views expressed by Delport,[877] Hendrikse and Hefer[878] and Wixley, Everingham and Louw[879] that the audit committee is a standalone organ of the company is the correct characterisation. This is premised on the fact that the audit committee is established or appointed by the company's shareholders. It derives its duties and powers

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[875] See point 2.3.1 in Chapter 2 of this thesis.
[876] See a summary of Chapter 2 conclusion in point 2.4 in Chapter 2 of this thesis.
[877] Delport P *Henochsberg's Commentary on the Companies Act 71 of 2008* (2017) 356.
[878] Hendrikse JW & Hefer L *Corporate Governance Handbook: Principle and Practice* 3 ed (2019) 389
[879] Wixley T, Everingham G & Louw K *Corporate Governance: The Directors' Guide* 5 ed (2019) 110.

directly from the legislation.[880] The division of powers among organs of the company is absolute and original.[881]

It has been argued that the audit committee of the company acts as a watch dog for stakeholders in general and shareholders in particular.[882] The reason for this is that various stakeholders, including shareholders, are not involved in the management of the business and affairs of the company. They rely on the effective functioning of the company's independent audit committee in the oversight of the financial reporting process and risk management, to safeguard the stakeholders' interests. The audit committee is the principal governance committee which has gained acceptance in the global business community,[883] particularly with the promulgation of the SOX Act in the USA and the governance code in the UK. In South Africa, the establishment of audit committees is a listing requirement at the JSE.[884] Therefore, for the audit committee to function independently and effectively, it should not be accountable to the board of directors. The reason for this is that the audit committee is expected to provide an independent and unbiased assessment regarding, among others, the financial and audit functions of the company and the board of directors is not only responsible for the management of the business and affairs of the company[885] but also is the focal point of the company's corporate governance.[886]

It is submitted that if the audit committee is to be characterised, as it should, as an independent organ of the company and accountable to the company's shareholders, then its independence and protection thereof would be reinforced. This would reduce the likelihood of the board of directors exercising undesirable control and exerting undue influence on the audit committee, thus curtailing possible interference with its oversight responsibilities. Some examples of interference with

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[880] S 94(7) and (8) of the Companies Act 2008; Also see Hendrikse JW & Hefer L *Corporate Governance Handbook: Principle and Practice* 3 ed (2019) 391.
[881] Delport P *Henochsberg's Commentary on the Companies Act 71 of 2008* (2017) 356.
[882] Chukwunedu OS & Okafor OG 'Repositioning the Audit Committee as an Effective Watchdog in Corporate Governance in Nigeria'(2010) vol 10 *Journal of the Management Sciences* 5; Marx B (2008) 21.
[883] Wixley T, Everingham G & Louw K *Corporate Governance: The Directors' Guide* 5 ed (2019) 146.
[884] See JSE Limited Listings Requirements para 3.84 available at https://www.jse.co.za/sites/default/files/media/documents/2019-04/JSE%20Listings%20Requirements.pdf (accessed on 06 May 2021).
[885] S 66(1) of the Companies Act 2008.
[886] *Mpofu* para 9. Also see Principle 6 under Part 5.3 of the *King IV Code*.

and undue influence on the members of the audit committee are highlighted in point 5.6 below. The board of directors has significant discretionary powers to fundamentally influence the successes or failures of the company.[887] It is imaginable that this includes the successes or failures of the audit committee.

5.3.1.2 Appointment by shareholders (Section 94(2) and section 61(8)(c)(ii))

These sections make provision for the election of members of the company's audit committee at the annual general meeting of the company's shareholders. Section 94(2) does not expressly provide for the appointment by shareholders. However, the word 'elect' in that subsection should be interpreted to mean that members of the audit committee so elected, are automatically (that is, without any further ratification) appointed. The reason for this is that lawful resolutions of shareholders of the company are binding on the company and its board of directors and need no further approval.[888] Further, section 61(8)(c)*(ii)* of the Companies Act 2008 provides clarity. This section prescribes that a public company must convene an annual general meeting of shareholders to appoint an audit committee. It is unimaginable that sections 94(2) and 61(8)(c)*(ii)* may envisage different procedures for appointment of members of the company's audit committee while the appointments under both sections emanate from exercise of power by the same organ of the company for the same legislative purpose.

The purpose of sections 94(2) and 61(8)(c)*(ii)* is seemingly to establish the independence of the audit committee. The reason for this is that both these sections make provision for the appointment of members of the audit committee by the company's shareholders at an annual general meeting. A director's relationship with a particular shareholder, his or her nomination and the subsequent election by that shareholder to serve on the audit committee of the company does not, *per se*, weaken the independence of the audit committee. This is premised on a well-established corporate law principle, that a director

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[887] Bekink M 'Indemnification and Aspects of Directors' and Officers' Liability Insurance in terms of Section 78 of the Companies Act 71 of 2008' (2011) 23 *SAMLJ* 88.
[888] S 65(6) of the Companies Act 2008.

owes his or her duties to the company and not the shareholder who nominated or voted for his or her appointment.[889] The court in *Fisheries Development Corporation of SA Ltd v Jorgensen and Another*[890] held that:

> A director is in that capacity not the servant or agent of the shareholder who votes for or otherwise procures his appointment to the board . . . The director's duty is to observe the utmost good faith towards the company and in discharging that duty he is required to exercise an independent judgment and to take decisions according to the best interests of the company as his principal. He may in fact be representing the interests of the person who nominated him, and he may even be the servant or agent of that person, but, in carrying out his duties and functions as a director, he is in law obliged to serve the interests of the company to the exclusion of the interests of any such nominator, employer or principal. He cannot therefore fetter his vote as a director, save in so far as there may be a contract for the board to vote in that way in the interests of the company, and, as a director, he cannot be subject to the control of any employer or principal other than the company.[891]

It is submitted that, the above passage from the judgment by Margo J applies, *mutatis mutandis*, to directors who hold membership to the company's audit committee. As a director of the company,[892] a member of the audit committee does not serve at the behest of the shareholder who nominated or voted for him or her, even if that member's appointment to the company's audit committee is to advance the interests of that shareholder.

Further, a subsidiary company, which is obligated to establish an audit committee, need not constitute such committee if the parent company has the audit committee[893] and that audit committee of the parent company will perform the statutory audit committee functions on behalf of that subsidiary company.[894] It is uncertain, however, whether the non-executive directors of a subsidiary company are eligible to serve on the audit committee of its parent company. Nevertheless, a literal reading of subsection (4)(a) appears to suggest that a

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[889] Delport P *Henochsberg's Commentary on the Companies Act 71 of 2008* (2017) 358.
[890] 1980 (4) SA 156 (T).
[891] 163D-G.
[892] S 94(4)(a) of the Companies Act 2008.
[893] Subsection (4)(2)(a).
[894] Subsection (4)(2)(b).

director referred to in that subsection must be a director of the company on whose audit committee he or she is appointed. For this reason, it is doubtful that directors of a subsidiary company could exert any undue influence on the activities of the audit committee of its parent company. It must be noted, nonetheless, that nothing in the Companies Act 2008 disqualifies directors of a subsidiary company from being appointed as directors of its parent company.

The provisions of sections 94(2) and 61(8)(c)*(ii)* appear to strengthen the independence of the company's audit committee. These provisions ensure that the appointment of members of the audit committee follows a transparent process involving the community of shareholders. This provides a mechanism to safeguard the independence of individual members and the committee as a whole, by reducing, if not eliminating, the likelihood of appointment of personal associates of the company's executive management or board of directors to serve on the company's audit committee.

5.3.1.3 Disqualified persons (Section 94(4)(b) and (c))

The Companies Act 2008 prohibits certain individuals and category of persons from being appointed to serve as members of the company's audit committee. Section 94(4)(b)*(i)* of the Companies Act 2008 states that a member of the company's audit committee must not be a director involved in the day-to-day management of the company or a director who has been involved in the day to day management of the company during the preceding financial year. Although this provision does not adequately ingrain the independence of the audit committee, the attempt is plausible. It would have been catastrophic if the Companies Act 2008 permitted executive directors of the company to serve as members of that company's audit committee, as the undue influence and interference with the independence of that audit committee would have been too obvious and unavoidable.

The Companies Act 2008 also prescribes that a member of the audit committee must not be any prescribed officer or a full time employee of the company or its related or inter-related company or any person who have been a prescribed officer or a full time employee at such a company at any time during the previous

three financial years.[895] In this respect, the legislative intention appears to be to avoid situations where directors or employees, who would have been party to the implementation of corporate governance practices, financial and reporting standards and production of financial statements, are appointed on the audit committee with an intention to provide oversight over that which they have been party to its implementation. In other words, the purpose is to disqualify, from appointment to serve as a member of the company's audit committee, any person who has direct or indirect interest in the company.

The Companies Act 2008 further excludes, from being appointed as a member of the audit committee, any material supplier or customer of the company if the circumstance would lead a reasonable and informed third party to conclude that the integrity, impartiality or objectivity of that material supplier or customer has been compromised by that supplier-company or customer-company relationship.[896] This prohibition is self-explanatory as it is presumably intended to prevent conflict of interests.

To avoid real or perceived undue direct or indirect influence or possible conflict of interests, the provisions of section 94(4)(c) of the Companies Act 2008 further prohibit, from being appointed to the company's audit committee, any person related to a director, who is or has, in the previous financial year, been an executive director of the company.[897] This subsection also precludes, from serving as a member of the audit committee, any person related to a director who is or has, in the preceding three financial years, been a prescribed officer or a full time employee of the company.[898] Finally, subsection (4)(c), read with subsection (4)(b)*(iii)* also excludes, from being a member of the audit committee, any person related to a material supplier or customer of the company in circumstances where a reasonable and informed third party could conclude that the integrity, impartiality or objectivity of that person (who is to be appointed as a member of the audit committee) is compromised. It is submitted that this disqualification of

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[895] Subsection (4)(b)(ii).
[896] Subsection (4)(b)(iii).
[897] Subsection (4)(c), read with subsection (4)(b)(i).
[898] Subsection (4)(c), read with subsection (4)(b)(ii).

certain persons for appointment as members of the audit committee serves to enhance and protect the independence of that committee.

5.3.2 Provisions which weaken the independence of the audit committee and protection thereof

5.3.2.1 Audit committee as a committee of the company's board of directors

It has been highlighted in Chapter 2,[899] that some leading corporate governance authors are of the view that the audit committee is a committee or subcommittee of the company's board of directors.[900] This is seemingly premised on the *King IV* recommendation that the audit committee of the company should be established or appointed by the company's board of directors.[901] Marx expresses the view that 'the audit committee should function as a subcommittee of the board of directors'.[902]

Under the Companies Act 2008, the proposition that the company's audit committee should be or is established by the company's board of directors appears to be drawn from, with respect, the misinterpretation of the provisions of sections 94(3)(b) and 94(6) of that Act. It is submitted that these provisions should be interpreted in light of the legislative effort to 'enhance accountability and transparency' as it appears from the title of Chapter 3 of the Companies Act 2008. The audit committee of the company is only established by the company's shareholders at the annual general meeting as contemplated in sections 94(2) and 61(8)(c)*(ii)*. It is submitted that the provisions of sections 94(3)(b) and 94(6) are only intended to maintain the institution or composition of the audit committee.

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[899] See the discussion in point 2.3.1 in Chapter 2 of this thesis.
[900] See Marx B (2008) 42; Ferreira I 'The effect of audit committee composition and structure on the performance of audit committees' (2008) vol. 16 no. 2 *Meditari Accountancy Research* 93; Ncube CB 'Transparency and accountability under the new company law' *Modern Company Law for a Competitive South African Economy* 67; Magrane J and Malthus S 'Audit Committee Effectiveness: A Public Sector Case Study' (2010) vol. 25 Iss: 5 *Managerial Auditing Journal* 427-443; Akwenye NJ, Chata T & Benedict OH 'Establishment of audit committee in government ministries of a developing country' *Risk Governance & Control: Financial Markets & Institutions* 285; Zábojníková G *The Audit Committee Characteristics and Firm Performance: Evidence from the UK* (Masters in Finance dissertation, Porto University, 2016) 1.
[901] See Recommended Practice 51 under Principle 8 of Part 5.3 of the *King IV Code;* Provision 24 of the Financial Reporting Council 'The UK Corporate Governance Code' (2018) 10.
[902] Marx B (2008) 42.

If it is to be accepted that the audit committee of the company is the subcommittee of the company's board of directors, it is submitted therefore that the interpretation by Cassim *et al* that such committee is accountable to the board of directors[903] is to be accepted too. This makes the audit committee to be on the same level and of the same status as board committees established in terms of provisions of section 72 of the Companies Act 2008. It is submitted that the board committees established in terms of section 72 of the Companies Act 2008 are not independent committees and need not enjoy any measure of independence. They are committees which function under the control and supervision of the company's board of directors. On the basis of the forgoing, it is further submitted that the audit committee that is characterised as the committee or subcommittee of the company's board of directors is susceptible to undue influence and interference with its functioning. This has the effect of weakening the independence of the audit committee.

5.3.2.2 Members of the audit committee as members of the board of directors (Section 94(4)(a))

The provisions of section 94(4) of the Companies Act 2008 endeavour to entrench the independence of the audit committee, specifically by prescribing that the members of the committee must be non-executive directors.[904] Theoretically, this provision offers a mechanism which protects the independence of the company's audit committee. However, on a practical level, this section and the related sections in the Companies Act 2008 may fall short of achieving the purpose it is purportedly intended for.

The Companies Act 2008 assigns the responsibility to manage the business and affairs of the company to the company's board of directors.[905] As discussed above, the Companies Act 2008 also requires the members of the company's audit committee to be directors of the company, who are not involved in the day-to-day management of the company. Hypothetically, this means that the board of the company, comprising of both executive and non-executive directors (including some

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[903] See Cassim et al *Contemporary Company Law* 3 ed (2021) 625.
[904] Subsection (4)(a), read with subsection (4)(b)(i).
[905] S 66(1) of the Companies Act 2008.

or all members of the audit committee), has direct or indirect influence on the workings of audit committee of the company. It was held in *Barlows Manufacturing Co Ltd v RN Barrries (Pty) Ltd* [906] that directors of the company (including members of audit committee – emphasis added) owe their fiduciary duty to the company and not to other directors or the board (own emphasis added).[907] However, it is submitted that nothing in the Companies Act 2008 prohibits the board of directors from engaging in robust discussions and battle of ideas, including persuading one another, with the aim of advancing the interests of the company. When a director, including a member of the audit committee, is persuaded by other directors, it does not necessarily mean that such a director has switched his or her allegiance from the company to the directors persuading him or her. However, it is further submitted that the persuasion of a member of the audit committee by his or her fellow board members, at the board level, in respect of audit committee related matters, could have catastrophic effect on the independence of that committee. The aforesaid may be exacerbated by the fact that the board of directors has the powers to delegate oversight functions to the audit committee[908] and such delegation does not reduce the functions and powers of the company's board.[909] This would incentivise the board of directors to exercise control over and interference with the functioning of the company's audit committee. The reason for this is that, while the board of directors may delegate its functions to the audit committee, it may not abdicate its overall oversight responsibility. It must retain the ultimate control[910] and responsibility. In this regard, it is submitted that the distinction between the executive or non-executive directors for the purpose of appointment to the audit committee makes little difference in respect of the independence of that committee.[911]

In light of the foregoing, some interesting questions may raise. An example of such questions is: from whom or what does the independence of the company's audit committee need to be protected? As the board of directors is the focal point of corporate governance[912] and has colossal powers to manage the business and

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[906] 1990 (4) SA 608 (C) 610
[907] See Cassim et al *Contemporary Company Law* 3 ed (2021) at 623.
[908] S 94(7)(i) of the Companies Act 2008.
[909] Subsection (10).
[910] *Barlows Manufacturing Co Ltd v RN Barrries (Pty) Ltd* 1990 (4) SA 608 (C) 611.
[911] Also see the discussion in point 2.2.2.1 of this thesis.
[912] *South African Broadcasting Corporation v Mpofu* para 9. Also see Principle 6 under Part 5.3 of

affairs of the company,[913] the above question may be asked more directly: is the audit committee being protected from undue influence of the company's board of directors, to safeguard its independence? If the answer is in the affirmative, then what could have been the legislative intention of permitting members of the company's board of directors, from which the Companies Act 2008 seeks to protect the independence of the audit committee, to serve as members of such audit committee?

Presumably, by having members of the company's board of directors serving on the audit committee, the lawmakers' intention could be to ensure free flow of information and to afford the board of the company an opportunity to provide input as regards the company's financial reporting processes and controls. This would be consistent with the board of directors' overall statutory and fiduciary responsibilities, including oversight over the performance of the company and its board's committees. However, it is submitted that the same outcome could be achieved in terms of provisions of section 94(7)*(h)* and *(i)* of the Companies Act 2008. Specifically, subsection (7)(h) allows the audit committee to make submissions to the company's board, regarding any matter concerning the company's accounting policies, financial controls and records, as well the reporting thereof. This would offer the board of the company an opportunity to provide the board's input on the workings of the company's audit committee and assign any further oversight responsibilities as contemplated in subsection (7)(i).

The key objective of the provisions dealing with the independence of the audit committee should be to ensure that such committee is completely independent of the company's board of directors.[914] As Sarkar and Sarkar argue, seeking the involvement of members of the company's board of directors should be a discretionary choice of the audit committee and not be obligated by law.[915] It is submitted that the involvement of members of the company's board of directors in

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the *King IV Code*.

[913] S 66(1) of the Companies Act 2008.

[914] Sarkar J & Sarkar S 'Auditor and audit committee independence in India' (2010), *Indira Gandhi Institute of Development Research, Mumbai Working papers* 25.

[915] Sarkar J & Sarkar S (2010) 25.

the structure and functioning of the audit committee has serious implications on the insulation of the independence of the company's audit committee.

5.3.2.3 The appointment by board of directors (Section 94(3)) and (Section 94(6))

An argument has been made above,[916] that the fact that members of the audit committee are appointed by the company's shareholders in terms of section 94(2) of the Companies Act 2008 makes such a committee an organ of the company, independent from other organs, particularly the board of directors. However, it is submitted that the provisions of section 94(3)(b) of the Companies Act 2008 disconcertingly reduce this independence, in so far as the section confers the appointing powers on the board of the directors of the company. What is even more troubling is the fact that the Companies Act 2008 allows the board to choose from amongst its own non-executive members and appoint them to the company's audit committee. This, in practical terms, means that the board is empowered to appoint itself to the company's audit committee.

The provisions of section 94(6) are not different. This subsection empowers the company's board of directors to 'fill any vacancy on the audit committee within 40 business days after the vacancy had arisen'. In compliance with subsection (6), the board of the company may appoint its own members to the company's audit committee, thus effectively ensuring that the board, through its members so appointed, have influence in the matters concerning the audit committee, including '…with respect to the appointment, fees and terms of engagement of the auditor'. This gives the board of the company complete control of the company's audit committee and inadvertently stretches the functions and duties of the board to also include the exceptions set out in section 94(10) of the Companies Act 2008.

[916] See the discussion in point 2.3.1 in Chapter 2 of this thesis.

5.3.2.4 The removal of members of the audit committee by the governing body

The provisions of the Companies Act 2008 dealing with the removal of members of the audit committee were discussed in Chapter 3.[917] This segment is only intended to illustrate how these provisions may affect the independence of the audit committee. For the ease of reference, some of the discussion in point Chapter 3 may be repeated in this segment.

It has been pointed out, that the Companies Act 2008 does not make any express provision for the removal of members of the audit committee from that committee. The directors of the company, including the members of the company's audit committee, may be removed from their position as directors by shareholders[918] or the board[919] or Companies Tribunal[920] or by court.[921] A director, including a member of the audit committee, who, while serving as a director, becomes disqualified in terms of section 162 of the Companies Act 2008, ceases to be eligible to continue to serve as a director.[922] However, whereas the Companies Act 2008 is clear on how a director of the company may be removed, it is ambiguous as to how a member of the audit committee may be removed from the committee. This may pose a challenge in situations where the company, either through its directors or shareholders, wishes to remove a director from its audit committee without removing that particular director from the position of non-executive director of the company.

The provisions of sections 94(2), 94(3)(b) and 94(6) of the Companies Act 2008 only deal with the appointment of members of the company's audit committee by shareholders and the board of directors. Neither these provisions nor any other provisions in the Companies Act 2008 set out any mechanism to remove members of the audit committee before expiration of their term of office. Accordingly, it is submitted that, while a shareholders' meeting may be convened any time,[923] it is not clear whether a shareholders' meeting may be convened

[917] See the discussion in point 3.2.4 in Chapter 3 of this thesis.
[918] S 71(1) of the Companies Act 2008.
[919] S 71(3) of the Companies Act 2008.
[920] S 71(8)(b) of the Companies Act 2008.
[921] In terms of section 71(6)(b)(ii) of the Companies Act 2008 or section 162 of the same Act.
[922] S 69(4) of the Companies Act 2008.
[923] In terms of section 61(1) of the Companies Act 2008.

any time to specifically consider a resolution to remove a member or members of the company's audit committee. The reason for this is that the business of establishment of the audit committee and appointment (and by necessary deduction, the removal) of members of that committee appears to be reserved for the company's annual general meeting as contemplated in sections 94(2) and 61(8)(c)*(ii)* of the Companies Act 2008. However, the removal of members of the audit committee may also be regulated in terms of the provisions of the company's MOI.[924]

It is trite that the board of directors of the company has, in terms of section 66(1) of the Companies Act 2008, the authority to exercise all powers and functions of the company, except where the Act or the company's memorandum of Incorporation states otherwise.[925] This provision puts the members of the board of the company, in a unique relationship with the company, with significant discretionary powers to fundamentally influence the successes or failures of the company.[926] Further, the appointment of the audit committee and the assignment of oversight responsibilities do not diminish the overall functions and duties of the company's board of directors.[927] Moreover, as highlighted in Chapter 3, the Companies Act 2008 does not prohibit the board from removing members of the company's audit committee from such committee. Thus, if the company's MOI does not specifically prohibit removal of members of the audit committee by the company's board of directors, then the board may exercise all powers and functions of the company, including the removal of the members of the audit committee. Further, it is unimaginable that the Companies Act 2008 could give the board of directors the powers to appoint members of audit committee,[928] without endowing on it, the analogous powers to remove such members. As it was found in *Masetlha v President of the Republic of South Africa and Another,* the power to remove or dismiss is necessary in order to exercise the power to

[924] Ncube CB 'Transparency and accountability under the new company law' *Modern Company Law for a Competitive South African Economy* 72.
[925] See *Westerhuis v Whittaker and Other* (4145/2017) [2018] ZAWCHC 76 (26 April 2018) para 18.
[926] Bekink M 'Indemnification and Aspects of Directors' and Officers' Liability Insurance in terms of Section 78 of the Companies Act 71 of 2008' (2011) 23 *SAMLJ* 88.
[927] S 94(10) of the Companies Act 2008.
[928] In terms of section 94(3)(b) and 94(6) of the Companies Act 2008.

appoint.[929] In this case, the court further found that a sound principle of constitutional or statutory construction is that, in the absence of constitutional or statutory provisions to the contrary, the power to remove must be considered to be incidental to the power to appoint.[930]

In light of the dictum in the *Masetlha* case, it is submitted therefore that the Companies Act 2008 does not protect the incumbency of members of the company's audit committee, thus weakening the independence of that committee. Another point to consider is that, while members of the company's audit committee are required to uphold the requirements of sections 75 and 76 of the Companies Act 2008, as well as their common law fiduciary duties, nothing in the Companies Act 2008 protects such members from possible victimisation, purging and arbitrary removal from the audit committee by the company's board of directors. This would make it difficult for members of the company's audit committee to discharge their functions without fear, favour or prejudice.

5.3.2.5 Section 94(10)

The provisions of section 94(10) of the Companies Act 2008 effectively reaffirm the provisions of section 66(1) of the same Act. It does so by stating that the appointment and duties of the audit committee do not reduce the functions and duties of the company's board of directors. In other words, the board of directors is, and despite the appointment of the audit committee, remains the only organ of the company responsible for the management of the business and affairs of the company. The exception is that the board of directors may only not interfere with the appointment of the auditor and determination of audit fees and terms of reference of the auditor as contemplated in section 94(10) of the Companies Act 2008. From the aforementioned, it appears that the provisions of section 94(10) empower the board of directors to interfere with the functions and duties of the audit committee except to the extent set out in that section. Conceivably, this interference may

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[929] *Masetlha v President of the Republic of South Africa and Another* 2008 (1) SA 566 (CC) para 68.
[930] *Masetlha v President of the Republic of South Africa and Another* 2008 (1) SA 566 (CC) para 168.

impede the work of the audit committee and erode the committee's independence and effectiveness.

It is not clear why the provision of section 94(10) of the Companies Act 2008 are necessary. As it has been shown throughout this study, the role of the audit committee is primarily of oversight nature.[931] It is submitted that such role does not include the management of the business and affairs of the company, because the audit committee is not the board of directors. Therefore, even if section 94(10) was not inserted in the Companies Act 2008, the result would still have been the same - that is that only the board of directors has the powers to manage or direct the management of the business and affairs of the company and exercise all the powers and perform all the functions of the company except to the extent that the Companies Act 2008 or the company's MOI may state otherwise. As already pointed out, the provisions of section 94(10) only encourage the board of directors to interfere with the functions, duties and role of the audit committee except to the extent stated in that section, thus weaken the committee's independence. In this respect, a recommendation will be made in Chapter 6 on how the provisions of section 94(10) could be improved to safeguard the functioning of the audit committee and its independence.

5.4 THE PROTECTION OF THE INDEPENDENCE OF THE AUDIT COMMITTEE UNDER THE PUBLIC FINANCE MANAGEMENT ACT

Under the PFMA, the duty and powers to establish the audit committee of an SOE are assigned to the entity's accounting authority.[932] The PFMA defines an accounting authority as the board of directors or other controlling body of the public entity.[933] Unlike the Companies Act 2008, Regulation 27.1.1 of the Treasury Regulation for PFMA states that 'the accounting authority of a public entity must establish an audit committee as a subcommittee of the accounting authority'.[934] Consequently, the audit committee of an SOE is accountable to the entity's

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[931] The functions and role of the audit committee were discussed in detail in Chapter 3 of this thesis.
[932] Regulation 27.1.1 of the Treasury Regulation for PFMA.
[933] S 49(2)(a) of the Public Finance Management Act 1 of 1999.
[934] Regulation 27.1.1 of the Treasury Regulation for PFMA.

accounting authority.[935] This may result in an objectionable effect that members of the audit committee of SOEs become beholden to or serving at the whim of the entities' accounting authorities. This negative effect is more likely to arise in circumstance where a member of the audit committee of a public entity is also a member of that entity's accounting authority.[936] This may subvert the independence of the audit committee as contemplated in Regulation 3.1.5 of the Treasury Regulations for PFMA.

Where the service of a member of the audit committee of a public entity is to be prematurely terminated by that entity's accounting authority, the relevant executive authority must concur with such termination.[937] Thus, the premature termination may be initiated by the accounting authority for concurrence by the executive authority. What is not clear though is whether it is possible for the premature termination of services of a member of the audit committee to be initiated by the executive authority, with the accounting authority concurring. Neither is it clear whether the executive authority may refuse, with or without good reason, concurrence with the accounting authority's premature termination of the services of a member of the audit committee and what is to be done when concurrence is withheld. However, a salutary principle of corporate law is that where an organ of governance such as the audit committee is appointed directly by an organ of the company such as shareholders or board of directors (or accounting authority, in the case of SOEs), it is that appointing body that has the powers to remove members of that organ of governance.[938] Accordingly, it is submitted that members of the audit committee of an SOE may only be removed by the entity's accounting authority. This is premised on the fact that as the executive authority does not have the powers under the PFMA to appoint members of the audit committee, no powers to remove such members

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[935] See Cassim et al *Contemporary Company Law* 3 ed (2021) 625, where it is suggested that, as a subcommittee of the board of directors, the audit committee is accountable to the company's board of directors (or accounting authority under the PFMA), save for the appointment, fees and terms of engagement of the auditor.

[936] Regulation 27.1.4 of the Treasury Regulation for PFMA.

[937] Regulation 27.1.5 of the Treasury Regulation for PFMA.

[938] Hendrikse JW & Hefer L *Corporate Governance Handbook: Principle and Practice* 3 ed (2019) 391. Also see the dictum in *Masetlha v President of the Republic of South Africa and Another* 2008 (1) SA 566 (CC) para 168, where it is stated that it is '…a sound principle of constitutional or statutory construction that, in the absence of constitutional or statutory provisions to the contrary, the power to remove must be considered to be incidental to the power to appoint'.

may conversely be implied. The fact that the executive authority must concur with any premature termination of services of a member of the audit committee as prescribed by Regulation 27.1.5 of the Treasury Regulation for PFMA suggests that such termination of services or removal of a member from the audit committee is not possible in circumstances where the executive authority's concurrence is withheld.

Although they must not constitute the majority, persons under the employ of the public entity may be appointed to that entity's audit committee.[939] However, such persons must be directors of the entity,[940] even if they need not be members of that entity's accounting authority.[941] It is submitted that whether they are members of the entity's accounting authority or not, directors of the SOE who have employment relationship with the entity cannot possibly be seen to be bringing an independent and unfettered mind to the entity's audit committee. For example, an executive director responsible for the entity's legal, governance, risk and compliance, who may or may not be a member of the entity's board of directors, is eligible to be appointed to the entity's audit committee in terms of the Treasury Regulations for PFMA. Notwithstanding the fact that such a director, who may, in the South African context, be a political appointee, owes his or her duty to the entity and is required to exercise independent judgment, his or her independence of mind and independence in appearance will be in doubt. The reason for this is that the director will have an 'interest, position, association or relationship with the company which, when viewed from the perspective of a reasonable and informed third party, is likely to cause undue influence or bias in his or her decision-making as a member of the audit committee'.[942]

The preceding discussion illustrates how the provisions of PFMA and its Treasury Regulations dealing with the audit committees of SOEs have the effect of weakening the independence, and protection of such committees. The fact that the audit committee is established by, reports to and is accountable to the accounting authority creates an environment in which the committee is not objectively expected

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[939] Regulation 27.1.4 of the Treasury Regulation for PFMA.
[940] S 94(4)(a) of the Companies Act 2008.
[941] Regulation 27.1.4 of the Treasury Regulation for PFMA.
[942] See *King IV Report* (2016) 13.

to discharge its responsibilities without fear or favour. The Zondo Commission found that there is a pattern of executive interference and political overreach at the SOEs.[943] In other words, it may be said that accounting authorities of public entities are highly politicised. Therefore, the fact that members of the audit committees of the public entity can only be appointed and removed by the entity's accounting authority exposes the individual members to possible undue interference with their independence and that of the committee as a whole. This is compounded by the fact that the audit committee of the public entity is duty bound to report members of the accounting authority implicated in acts of fraud, corruption or gross negligence to the relevant executive authority and the Auditor-General.[944] Thus, the members of the audit committee may individually or collectively be stirred to toe the line in fear of possible removal from the committee before expiry of their term of office.

5.5 DOES THE DIRECTORS' INDIVIDUAL INDEPENDENT JUDGMENT PROMOTE AND PROTECT THE INDEPENDENCE OF THE AUDIT COMMITTEE?

Every director of the company should give the company the benefit of his or her independent judgment when deliberating on issues of policy or matters affecting the company.[945] This position is expressed succinctly in case law. Margo J, in *Fisheries Development Corporation of SA Ltd v Jorgensen and Another*, held that 'the director's duty is to observe the utmost good faith towards the company, and in discharging that duty he is required to exercise an independent judgment and to take decisions according to the best interests of the company as his principal'.[946] It is expected of a director to consider the affairs of the company in an unbiased and objective manner.[947]

Interestingly, the Companies Act 2008 does not specifically pronounce on the independence of directors of the company. The reason for this omission may be that the duty of good faith entails the duty to exercise an independent judgment.[948]

[943] See the Judicial Commission of Inquiry into Allegations of State Capture, Corruption and Fraud in the Public Sector including Organs of State Report: Part 1 Vol. 1: Chapter 1 – South African Airways and its Associated Companies at para 436.
[944] Regulation 27.1.11 of the Treasury Regulation for PFMA.
[945] Mupangavanhu BM (2016) 24.
[946] 1980 (4) SA 156 (W) 163.
[947] Cassim et al *Contemporary Company Law* 3 ed (2021) 714.
[948] Cassim et al *Contemporary Company Law* 3 ed (2021) 707.

However, the independence of a director of the company is implied in section 76(3) of the Companies Act 2008. When exercising their powers and performing their functions as directors, individual directors are required to act in good faith and for a proper purpose;[949] act in the best interest of the company;[950] and with the degree of care, skill and diligence.[951] This also applies to individual members of the audit committee as directors of the company.[952] It is said that the independence of a director is judged by whether that director makes a decision based on merits of the issue or is being influenced by extraneous considerations.[953] This includes the director's duty to avoid conflict of interests.[954] For this reason, the duty to exercise an independent judgment forms part of the fiduciary and statutory duties of directors.[955]

The question is, therefore, whether the director's independent judgment has the effect of promoting and protecting the independence of the audit committee as a whole. The question may be asked differently, thus: does the fact that the audit committee is comprised of directors of the company who are expected to exercise independent judgment instill any measure of independence in that committee? Ideologically, it appears that, under the Companies Act 2008, the idea of independent audit committee is wholly based on the common law and statutory requirement that directors of the company must exercise independent judgment. This expression is deduced from the provisions of section 94(4)(2) of the Companies Act 2008, which prescribe that each member of the audit committee must be a director of the company. Presumably, this is to ensure that the common law and statutory requirements that directors must exercise an independent judgment also applies to individual members of the audit committee. Nevertheless, as demonstrated in Chapter 3, the method of appointment and removal of members is

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949 S 76(3)(a) of the Companies Act 2008.
950 S 76(3)(b) of the Companies Act 2008.
951 S 76(3)(c) of the Companies Act 2008.
952 See s 76(1)(b) and s 94(4)(a) of the Companies Act 2008.
953 Muswaka L 'Shielding Directors against Liability Imputations: The Business Judgment Rule and Good Corporate Governance' [2013] *SPECJU* 2.
954 See s 76(2)(a) of the Companies Act 2008.
955 Cassim et al *Contemporary Company Law* 3 ed (2021) 714-718.

an important factor that bears relevance to the independence of an office or institution or committee which is required to be independent in terms of any law.[956]

From the foregoing, the supposition that because members of the audit committee are required to exercise independent judgment of directors, the whole committee will therefore enjoy some degree of independence is doubtful. The Constitutional Court in *AmaBhungane Centre for Investigative Journalism NPC and Another*[957] confirmed the High Court's declaration of unconstitutionality of the Regulation of Interception of Communications and Provision of Communication Related Information Act 70 of 2002 ('RICA') to an extent that it fails to provide for safeguards to ensure that a Judge designated in terms of section 1 of that Act is sufficiently independent. The court reached this conclusion despite the legal presumption that Judges are independent. In this regard, the court reasoned that there may be factors that conduce to a perception of lack of independence even in the case of a Judge.[958] Applying this reasoning, it may be argued that factors such as the manner of appointment and removal of members of the audit committee conduce to a perception of lack of independence of that committee, despite the fact that individual members are presumed to exercise independent judgment as directors.

It is submitted that it is not helpful for the body from which the audit committee must be independent to have the power to appoint and remove members of that committee. This does little to promote and protect the independence of the individual members and the audit committee as a whole. On the contrary, it threatens such independence and its protective mechanisms. It is submitted that, for the audit committee to be independent in fact and in perception, it must take stringent measures which are much more than the presumption of director's independent

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[956] See *Corruption Watch NPC and Others v President of the Republic of South Africa and Others; Nxasana v Corruption Watch NPC and Others* (CCT 333/17; CCT 13/18) [2018] ZACC 23; 2018 (10) BCLR 1179 (CC); 2018 (2) SACR 442 (CC) (13 August 2018) para 22. Also see *McBride v Minister of Police and Another* (CCT255/15) [2016] ZACC 30; 2016 (2) SACR 585 (CC); 2016 (11) BCLR 1398 (CC) (6 September 2016) para 31.

[957] *AmaBhungane Centre for Investigative Journalism NPC and Another v Minister of Justice and Correctional Services and Others; Minister of Police v AmaBhungane Centre for Investigative Journalism NPC and Others* (CCT 278/19; CCT 279/19) [2021] ZACC 3 (4 February 2021).

[958] *AmaBhungane Centre for Investigative Journalism NPC and Another v Minister of Justice and Correctional Services and Others; Minister of Police v AmaBhungane Centre for Investigative Journalism NPC and Others* (CCT 278/19; CCT 279/19) [2021] ZACC 3 (4 February 2021) para 92.

judgment. The reporting and accountability lines of, as well as subscription and termination of membership to, that committee are such measures.

5.6 DO DIRECTORS' PERSONAL LIABILITY, INDEMNIFICATION & DIRECTORS' INSURANCE ENHANCE INDEPENDENCE OF THE AUDIT COMMITTEE?

The provisions dealing with the liability of directors of the company are set out in section 77 of the Companies Act 2008 and will not be discussed in detail, save for the purpose of illustrating circumstances under which members of the audit committee may incur personal liability, when discharging their responsibilities as members of that committee.

As already stated, the Companies Act 2008 prescribes that each member of the company's audit committee must be a director of the company.[959] This appears to ensure that the directors' personal liability provisions set out in section 77 of the Companies Act 2008 also apply to members of the audit committee. However, if that is the case, it seems that the provisions of section 94(4)(a) of the Companies Act 2008 may be redundant in so far as the section prescribes that each member of the audit committee must be a director of the company. The reason for this is that the definition of a director in section 77 for the purpose of liability of directors already includes *a person who is a member… of the audit committee of the company*.[960] Nonetheless, a member of the audit committee may be held liable under common law for breach of their common law fiduciary duties and the statutory duties set out in sections 75 and 76 of the Companies Act 2008.[961] A member of the audit committee may also be held personally delictually liable in accordance with the principles of the common law[962] for any loss, damage or costs sustained by the company arising from the breach of the statutory duty of care.[963]

There currently are no records of literature or court cases dealing with the personal liability of directors of the company *qua* their role as members of the company's audit committee in South Africa. However, it is submitted that a member of the audit

[959] S 94(4)(a) of the Companies Act 2008.
[960] S 77(1)(b) of the Companies Act 2008.
[961] S 77(2)(a) of the Companies Act 2008.
[962] S 77(2)(b) of the Companies Act 2008.
[963] S 77(3)(c) of the Companies Act 2008.

committee may, in addition to the liability mentioned in section 77(2) of the Companies Act 2008, also be held liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director having signed, consented to, or authorised, the publication of any financial statements that were false or misleading in a material respect.[964] The financial statements referred to in subsection (3)(d)*(i)* includes annual financial statements.[965] As demonstrated in the preceding chapters, the audit committee has an important financial oversight responsibility[966] and the responsibility to improve the quality of the financial reporting process and the accuracy, integrity and reliability of the financial statements,[967] among other responsibilities. For this reason, it appears that members of the audit committee may be held liable for failure to act in good faith or in the best interests of the company or with the degree of care, skill and diligence in respect of their financial statements and reporting duties, as well as their oversight of the audit and risk functions of the board and the company.

From the foregoing, the question is whether directors' personal liability in terms of section 77 of the Companies Act 2008 could encourage individual members of the audit committee and the committee as a whole to act with an independent mind to avoid potential personal liability? Theoretically, the answer should be in the affirmative. However, the highly publicised private and public sector corporate scandals in South Africa suggest a different account. For example, Advocate Motau's VBS Mutual Bank investigative report ('the VBS Bank Report')[968] painted a worrying depiction involving the independence of the audit committee of the now defunct VBS Bank. The VBS Bank Report revealed how a non-executive director of that Bank, who was also a chairperson of that Bank's audit committee, had received personal benefits in the form of 'unlawful payments' made to his nominee company.[969] The VBS Bank Report further found that the chairperson of that Bank's

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[964] S 77(3)(d)(i) of the Companies Act 2008.

[965] See definition of 'financial statements' in s 1 of the Companies Act 2008.

[966] Marx B and du Toit E 'The impact of accounting standards developments and financial reporting complexities on the audit committee' (2009) 3(2) Journal of *Economic and Financial Sciences* 121.

[967] Marx B and Els G 'The role of the audit committee in strengthening business ethics and protecting stakeholders' interests' (2009) vol. 4 No. 1 *African Journal of Business Ethics* 8.

[968] Advocate Motau SC 'The Greatest Bank Heist: Investigator's Report to the Prudential Authority' (2018).

[969] Advocate Motau SC 'The Greatest Bank Heist: Investigator's Report to the Prudential Authority'

audit committee was ‘thoroughly corrupted by the unlawful rewards he received’ and therefore ‘there was no honest person occupying the vital position of audit committee chairperson’.[970] At the center of this worrying collapse of corporate governance at the VBS Bank was the chairperson of that Bank’s board of directors, who ‘dominated and determined what the board could or could not do’.[971] This included the concealment of fraudulent misrepresentations of the Bank's audited annual financial statements and other fraudulent misrepresentations that were made in the monthly regulatory returns that the Bank was obliged to make to the Registrar of Banks.[972] On this basis, it cannot be reasonably argued that the audit committee of the VBS Bank enjoyed any measure of independence.

In another example, the court in *Organisation Undoing Tax Abuse and Another v Myeni and Others*, heard how the chairperson of the board of directors and the chairperson of the audit committee of an SOE had connived to prepare and sign a board submission which was misrepresented as an official board resolution.[973] The court further observed that the chairperson of the board later conceded that the board submission was in fact irregular.[974] The VBS Bank and the *Myeni* examples exhibit the fact that members of the audit committee, including those who hold the key position of chairperson, often engage in a conduct which does not demonstrate any measure of independence, despite the possibility of incurring personal liability in terms of the provisions section 77 of the Companies Act 2008.

Where a director of the company has acted in good faith and for proper purpose or in the best interests of the company or with the degree of care, skill and diligence, such directors may be indemnified by the company in terms of the provisions of

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(2018) para 21.6.

[970] Advocate Motau SC ‘The Greatest Bank Heist: Investigator’s Report to the Prudential Authority’ (2018) para 57.

[971] Mupangavanhu BM 'Banking Crises in South Africa: Some Lessons for Corporate Governance and the Regulation of Banks' (2021) vol. 10 *Interdisciplinary Journal of Economics and Business Law* 57.

[972] Advocate Motau SC ‘The Greatest Bank Heist: Investigator’s Report to the Prudential Authority’ (2018) para 18.2; Mupangavanhu BM 'Banking Crises in South Africa: Some Lessons for Corporate Governance and the Regulation of Banks' (2021) vol. 10 *Interdisciplinary Journal of Economics and Business Law* 57-58.

[973] *Organisation Undoing Tax Abuse and Another v Myeni and Others* (15996/2017) [2020] ZAGPPHC 169 (27 May 2020) para 259.

[974] *Organisation Undoing Tax Abuse and Another v Myeni and Others* (15996/2017) [2020] ZAGPPHC 169 (27 May 2020) para 259.

section 78 of the Companies Act 2008 for any liability arising out of that director's conduct.[975] The MOI of the company may negate, restrict, limit, qualify or extend the indemnification of directors as contemplated in section 78(5) of the Companies Act 2008. However, any provision of an agreement, the MOI or rules of a company, or a resolution adopted by a company, whether express or implied, is void to the extent that it directly or indirectly purports to relieve a director of the duties set out in section 75 and 76 and the liability in terms of section 77 of the Companies Act 2008.[976] Further, the company may purchase and maintain an insurance policy to protect a director against any liability or expenses for which the company is permitted to indemnify such director.[977] It must be noted that the provisions of section 78 of the Companies Act also apply to members of the company's audit committee.[978] It is submitted that the indemnification of directors and directors' insurance may encourage members of the audit committee to act with a degree of independence, with the knowledge that the indemnification and insurance only apply to liability flowing from *bona fide* conduct.

5.7 DOES THE AUDIT COMMITTEE NEED ABSOLUTE INDEPENDENCE & PROTECTION?

Throughout this study, it has been canvassed how critically important it is for the audit committee to enjoy a greater measure of independence. It has been shown that, to improve its efficacy and stakeholder confidence, the audit committee must be independent from the company's board of directors and management. Beasley *et al* correctly observe that members of audit committee are often approached to serve on the committee because of their connections to members of the board of directors or management.[979] This suggests that the board of directors and management could have a significant effect on the independence of the audit

[975] See s 78(5) of the Companies Act 2008
[976] S 78(2)(a) of the Companies Act 2008. This is in line with the common law position that no provision in the company's articles or in any contract binding the company can effectively exempt a director from, or indemnify him against, liability for breach of any fiduciary (See Delport P *Henochsberg's Commentary on the Companies Act 71 of 2008* (2017) 307).
[977] S 78(7)(a) of the Companies Act 2008.
[978] S 78(1)(b) of the Companies Act 2008.
[979] Beasley et al 'The Audit Committee Oversight Process' (2009) 26 (1) *Contemporary Accounting Research* 81.

committee.[980] Kumar and Singh assert that ensuring audit committee independence will assure its members' independence in conflicting situations.[981] Imaginably, such conflict situations may arise between the audit committee or the auditor and management or the board of directors. Therefore, the independence of the audit committee will warrant auditor independence and this may lead to good audit quality.[982]

It has also been demonstrated that the central feature of an effective audit committee is its independence.[983] It must be underscored that such independence is ideally achieved by ensuring appointment of non-executive directors to serve on the audit committee.[984] It is argued that the greater members' collective independence, the better the audit committee is able to add value through objective and impartial advice.[985] However, it is not clear from the assessment of the available literature as to whether the conceptualisation of the audit committee requires that such committee be absolutely independence. In South Africa, neither the Companies Act 2008 nor the PFMA provides a clear indication as to the level of independence required of audit committees. While the PFMA regulations demand that audit committees of SOEs be constituted so as to ensure their independence,[986] the Companies Act 2008 does not make any express mention of independence in the constitution of the audit committee. As already pointed out, the independence of the audit committee, under the Companies Act 2008, is only implied in terms of section 94(4) of that Act. Therefore, the question as to what level of independence is required for an audit committee of the company to function effectively arises. The

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[980] See Cohen J et al 'The Impact on Auditor Judgments of CEO Influence on Audit Committee Independence and Management Incentives' (2011) *Forthcoming: Auditing: Journal of Practice & Theory* 3.

[981] Kumar N & Singh JP 'Audit Committee: Does it Signify as an Independent Watchdog Over and Above External Auditors' (2013) Available at SSRN: https://ssrn.com/abstract=2235126 or http://dx.doi.org/10.2139/ssrn.2235126 (accessed on 20 August 2020).

[982] Kumar N & Singh JP (2013).

[983] Global Institute of Internal Auditors *Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations* (2014) 12; Al-Mahamid SM & Al–Sa'eed 'Features of an effective audit committee, and its role in strengthening the financial reporting: Evidence from Amman Stock Exchange' (2011) vol. 1, no. 1 *Journal of Public Administration and Governance* 40; Bhasin 'Strengthening corporate governance through an audit committee: An empirical study' (2016) vol 23 no. 2 Wulfenia Journal 11.

[984] See Braiotta JR et al *The Audit Committee Handbook* 5 ed (2010) 47.

[985] Magrane J and Malthus S 'Audit Committee Effectiveness: A Public Sector Case Study' (2010) vol. 25 Iss: 5 *Managerial Auditing Journal* 427-443.

[986] Regulation 3.1.5 of the Treasury Regulation for PFMA.

question may be posed differently thus: does the audit committee require an absolute independence?

It is suggested that there is a connection between a higher level of independence of the audit committee and positive outcomes,[987] such as an improved monitoring and oversight of the financial reporting process.[988] In the United States of America, the SOX Act requires the audit committees of the companies listed on New York Stock Exchange ('NYSE') to be 100 per cent independent.[989] Similarly, section 94(4) Companies Act 2008 prescribes that all members of the audit committee must be directors of the company who are implicitly[990] independent. However, there appears to be a view that 100 per cent independence requirement may be too restrictive and without merit, and may result in the cost of having a completely independent audit committee overweighing the potential benefit.[991] It is submitted that, considering the global financial irregularities and corporate governance collapses of the recent times, no cost may be greater than the value of having an audit committee which is wholly independent from boards of directors and management. Simply put, there is no greater costs to the company than the company's failure due to poor financial and risk management by reason of ineffective audit committee.

It is further argued that the independence of the board of directors is a determinant of the independence of the audit committee.[992] This is consistent with the dictum in *Helen Suzman Foundation v President of the RSA and Others; Glenister v President of the RSA and Others*, that the independence of an institution depends pivotally on the independence of those who staff it.[993] However, as it has been propounded throughout this thesis, there is a greater need for the independence of the audit committee to be protected from those who are enjoined with the powers to manage

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[987] Bronson NS et al 'Are fully independent audit committees really necessary?' (2009) *J. Account. Public Policy* 268.

[988] Bronson NS et al (2009) 267.

[989] S 301 of Sarbanes-Oxley Act 2002; Also see the discussion in point 4.3 in Chapter 4 of this thesis.

[990] In terms of s 94(4) of the Companies Act 2008.

[991] Bronson NS et al (2009) 267.

[992] Zhang Y, Zhou J & Zhou N 'Audit committee quality, auditor independence, and internal control weaknesses' (2007) 26 *Journal of Accounting and Public Policy* 317.

[993] *Helen Suzman Foundation v President of the Republic of South Africa and Others; Glenister v President of the Republic of South Africa and Others* (CCT 07/14, CCT 09/14) [2014] ZACC 32; 2015 (1) BCLR 1 (CC); 2015 (2) SA 1 (CC) (27 November 2014) para 153.

the company's business and affairs – which is the board of directors.[994] It was further argued in this thesis that the legislative intention of the provisions of section 94 of the Companies Act 2008 must not merely be to establish another subcommittee of the company's board of directors, but rather to establish a standalone committee, independent from the board of directors. Therefore, it is submitted that the independence of the audit committee cannot be positively linked with the independence of the body from which the committee ought to be independent. For this reason, it is submitted that the audit committee must be completely independent from the board of directors.

5.8 CONCLUSION

This chapter has provided the necessary context within which the concept of independence as it relates to the audit committee must be understood. It has been shown that, as the independence of the audit committee depends on the independence of those who staff it, there cannot be a positive link between the audit committee and those from whom the committee must be independent. In other words, the audit committee ought to be independent from those who appoint it and its members.[995]

This chapter has also highlighted both the strengths and weaknesses in respect of the provisions of the Companies Act 2008 and the PFMA which deal with the independence of the audit committee and protection thereof.[996] Importantly, it has been demonstrated that section 94(2), read with subsection (4), of the Companies Act 2008 contemplates establishment of an independent and standalone committee of the company distinct from the board committees established in terms of section 72 of the same Act.[997] A different interpretation will have the effect of stripping the audit committee off its independence and protection thereof.

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[994] S 66(1) of the Companies Act 2008.

[995] In its current form, the Companies Act 2008 makes provision for the appointment of members of the audit committee by shareholders in terms of section 94(2). It also makes provision for appointment of members of the audit committee by the board of directors in terms of sections 94(3)(b) and s 94(6).

[996] See the discussions in point 5.3.1, point 5.3.2 and point 5.4 in Chapter 5 of this thesis.

[997] See the discussion in point 5.3.1.1 in Chapter 5 of this thesis.

Ideologically, the independent judgment of individual members of the audit committee *qua* directors of the company should buttress the independence of the audit committee as a whole. However, it has been shown in this chapter that this is not necessarily always the case. The troubling revelations contained in the VBS Bank Report and the *Organisation Undoing Tax Abuse and Another v Myeni and Others* case indicate that members of the audit committee of the company may, at times, outsource their individual independent judgment from other directors. This happens despite the possibility that members of the audit committee may incur personal liability in terms of section 76 of the Companies Act 2008.

As Kumar and Singh argue, academics and regulators have greater responsibility for ensuring the development of the audit committee as an important watchdog, so that the wealth of shareholders can be prevented from corporate frauds and scams.[998] The work in this chapter is aimed at serving such a purpose, with necessary recommendations proffered in the next chapter.

[998] Kumar N & Singh JP (2013).

CHAPTER 6: CONCLUSIONS - FINDINGS AND RECOMMENDATIONS

6.1 INTRODUCTION

This research employed a desktop methodology to critically examine the independence of the audit committee in South Africa, with reference to the provisions of the Companies Act 2008 and the PFMA. It sought to and has answered the question as to whether the South African audit committees are independent and that such independence is adequately protected.[999] This study has further highlighted the connection between the independence of the audit committee and the committee's effectiveness.[1000]

This closing chapter highlights some key points from Chapters 1 to 5 and how each chapter contributed to this study. Chapter 6 further presents a summary of the findings of this thesis and sets out recommendations and makes a case for possible legislative reform.

6.2 SUMMARY OF KEY FINDINGS

6.2.1 Summary of Chapter 1 findings

Chapter 1 of this thesis provided a synopsis of the concept of audit committee. In this respect, it was highlighted that the audit committee is not a new invention. It has been in existence for decades, albeit with some challenges, globally.[1001] Over the years, the world has been rocked by an assortment of shocking financial irregularities and corporate governance scandals. This includes, among many others, the Enron and WorldCom scandals in the USA, the challenges faced by the Barings Bank and Carillion PLC in the UK, Securency in Australia, Olympus Corporation in Japan, Petrobras in Brazil, and Steinhoff, Tongaat Hulett Limited, SAA and VBS Bank in South Africa.[1002] It was said that these financial irregularities

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[999] The main research question and sub-questions are outlined in point 1.4 in Chapter 1 of this thesis.
[1000] See the discussions in point 3.2 in Chapter 3 of this thesis.
[1001] See the discussions in point 1.1 in Chapter 1 and 4.2.1 in Chapter 4 of this thesis.
[1002] See the discussions in point 1.2 in Chapter 1 of this thesis; For some examples of some high profile financial irregularities and corporate governance collapses, see Mallin AC *Corporate Governance* 6 ed (2018) 2-8.

and corporate governance challenges happened despite the existence of audit committees in many of these organisations.[1003]

From the foregoing, the central research question was whether the independence of the audit committee of privately-owned companies and state-owned enterprises ('SOEs') is adequately protected under the Companies Act 2008 and the PFMA.[1004] It is worth restating that the independence of the audit committee and the protection of such independence are necessary for the improvement of the functioning and effectiveness of that committee. An effective audit committee would improve the integrity and quality of the financial reporting process, strengthen the committee's audit function oversight role, enhance the auditor's independence, enforce regulatory and legislative compliance, and promote good corporate governance for the benefit of the organisation's community of stakeholders.[1005]

In investigating the main research question, this study employed a theoretical desktop methodology, which included the evaluation of the existing literature, the applicable legislation, case law and comparative analysis.[1006] The evaluation of the existing literature highlighted the gap in the area of the audit committee, which justified the need to undertake this study. It was demonstrated in Chapter 1 that the leading corporate law and governance authors have generally investigated the effectiveness of the audit committee, focusing primarily on the committee's composition and functions.[1007] No literature dealing specifically with the independence of the audit committee and protection thereof could be found.[1008]

The overall objective of this study has been to demonstrate that the legislative provisions dealing with the independence of the audit committee under the Companies Act 2008 and the PFMA are riddled with some weaknesses, which give the board of directors and governing bodies of public entities a leeway to interfere with the functioning and independence of audit committees. This was achieved by undertaking further sub-inquires in the subsequent chapters.[1009]

[1003] See Marx B (2008) 10.
[1004] See the discussion in point 1.4 in Chapter 1 of this thesis.
[1005] See the discussion in point 1.3 in Chapter 1 of this thesis.
[1006] See the discussion in point 1.6 in Chapter 1 of this thesis.
[1007] See the discussion in point 1.5 in Chapter 1 of this thesis.
[1008] See the discussion in point 1.5 in Chapter 1 of this thesis.
[1009] See the main question and sub-questions in point 1.4 in Chapter 1 of this thesis.

6.2.2 Summary of Chapter 2 findings

The expositions in Chapter 2 have aided to locate the position of the audit committee within the sphere of corporate governance.[1010] It was demonstrated that the audit committee plays a significant role in corporate governance. It does this not only by its oversight role over the financial reporting process, the system of internal control and risk management but also by its oversight over compliance with the legislative and regulatory framework in the organisation. In this respect, it was found that the responsibilities of the audit committee include the requirement to contribute to an improvement in the corporate governance of the organisation.[1011]

In answering the central question, a number of sub-inquiries were undertaken. This includes the question of whether the audit committee is a subcommittee of the board of directors or a standalone organ of the company.[1012] The answer to this question is important for proper characterisation of the audit committee within the South African corporate structure. This characterisation should be consistent with the relevant object of the Companies Act 2008, particularly with respect to encouraging transparency and accountability as set out in section 7(b)(iii) of that Act.

This study found a divergence of views as to whether the audit committee under the Companies Act 2008 is a subcommittee of the company's board of directors or a standalone organ of the company. This was discussed in detail in point 2.3.1 in Chapter 2 above. It was argued in Chapter 2 that the audit committee, as a crucial corporate governance mechanism, is not or ought not to be a subcommittee of the company's board of directors. It is or must be a standalone independent committee of the company, appointed by and accountable to the company's shareholders in a meeting. The idea of the audit committee being accountable to the shareholders in a meeting must not be misconstrued to suggest that the directors of the company, who serve on the company's audit committee, owe their fiduciary duties to the shareholders. It is a trite corporate law principle that all directors of the company, including members of the audit committee, owe their fiduciary duties to the company

[1010] See the discussion in point 2.3.1 in Chapter 2 of this thesis.
[1011] van der Nest et al (2008) 555; Also see the discussion in point 2.2.7 in Chapter 2 of this thesis.
[1012] See the discussion in point 2.3.1 in Chapter 2 of this thesis.

as a juristic person with separate legal personality.[1013] As it was argued in point 2.3.1 in Chapter 2, the subcommittees of the company are contemplated in section 72 of the Companies Act 2008 and the audit committee should not be considered to be one of them. The audit committee may be termed as a section 94 committee.

Chapter 2 of the study has also demonstrated a crucial connection between the audit committee and other key stakeholders of the company. Significantly, it has been shown that the company's creditors may place a certain level of reliance on the work of the audit committee.[1014] As the overseer of the audit function and the financial reporting process, the audit committee provides assurance that the solvency and liquidity position of the company as it appears on the company's financial statements is accurate. The creditors of the company depend on the financial position of the company to make informed business decisions. It is clear that the audit committee's role is of cardinal importance to risk management, financial integrity and sustainability of a company.

Overall, Chapter 2 has shown why the audit committee should be independent and from whom this independence is necessary. As it was held in *Mpofu*, the board of directors is the focal point of corporate governance.[1015] *King IV* buttresses this point.[1016] It is the board of directors alone that is tasked with the management of the business and affairs of the company to the extent that the company's MOI may provide otherwise.[1017] For this reason, it was argued that the audit committee must be independent and protected from the board of directors.[1018] This study could not find the need for the audit committee to be protected from the company's stakeholders, such as shareholders, suppliers, employees and customers, as these stakeholders are not involved in the management of the business and affairs of the company. These stakeholders have very little to no interaction with the audit committee. An adequate independence and protection of the audit committee from

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[1013] *Cohen v Segal* 1970 (3) SA 702 (W) 706; *Fisheries Development Corporation of SA Ltd v Jorgensen and Another* 1980 (4) SA 156 (T) 163D-G; *Barlows Manufacturing Co Ltd v RN Barrries (Pty) Ltd* 1990 (4) SA 608 (C); Cassim et al *Contemporary Company Law* 3 ed (2021) 687; Delport P *Henochsberg's Commentary on the Companies Act 71 of 2008* (2017) 358.
[1014] See the discussion in point 2.3.4 in Chapter 2 of this thesis.
[1015] *South African Broadcasting Corporation v Mpofu* para 9.
[1016] See Principle 6 under Part 5.3 of the *King IV Code*.
[1017] S 66(1) of the Companies Act 2008.
[1018] See the discussion in point 4.3.3 in Chapter 3 and point 5.7 in Chapter 5 of this thesis.

the board of directors would improve the effectiveness of that committee and promote transparency and high standards of corporate governance as contemplated in section 7(b)*(ii)* of the Companies Act 2008.

For the SOEs, the Treasury Regulations for PFMA make an express statement that the audit committee must be established as a subcommittee of the entity's accounting authority.[1019] It has been argued in Chapter 2 that the fact that the audit committee of a public entity must be appointed by the entity's accounting authority as a subcommittee of that authority is problematic to the extent that it appears to be inconsistent with Regulation 3.1.5 of the Treasury Regulations for PFMA.[1020] The Regulation 3.1.5 of the Treasury Regulations for PFMA dictates that the audit committees under the PFMA must be established in a manner that ensures their independence. It is submitted that the independence contemplated in Regulation 3.1.5 of the Treasury Regulations for PFMA is independence from those who possess the power of influence, that it the accounting authority.

6.2.3 Summary of Chapter 3 findings

The size of the audit committee matters. It was found in Chapter 3 that there is a link between the size of the company's audit committee and the committee's efficiency and effectiveness.[1021] Though the size of the audit committee should be determined with the size, the complexity and the nature of the company in mind, it is suggested that a typical audit committee would have four to five members.[1022] The exposition in Chapter 3 found that the smaller the size of the audit committee in relation to the size and nature of the company, the higher the likelihood of that audit committee becoming thin on the diversity of skills and expertise, as well as complementary backgrounds.[1023] Equally, while an increased number of members of the audit committee may provide an effective oversight, a bigger and bloated audit

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[1019] Regulation 27.1.1 of the Treasury Regulation for PFMA; See the definition of 'accounting authority' in point 2.2.5.1 in Chapter 2 of this thesis.
[1020] See the discussion in point 2.3.2.2 in Chapter 2 of this thesis.
[1021] See the discussion in point 3.2.1.1 in Chapter 3 of this thesis.
[1022] Global Institute of Internal Auditors 'Global Public Sector Insight: Independent Audit Committees in Public Sector Organizations' (June 2014) 10.
[1023] See the discussion in point 3.2.1.1 in Chapter 3 of this thesis.

committee may lack the necessary efficacy.[1024] Therefore, it is recommended that an appropriate balance be ensured in this regard.

It was further found that the independence and objectivity of individual members of the committee, the selection process and appointment of new members are some of the critical factors affecting the independence and effectiveness of the company's audit committee. Another critical factor was found to be the diversity of skills and qualification backgrounds of members of the audit committee. Although the qualification matrix for members of the audit committee is determined by the Minister,[1025] it must be noted that the members of the company's audit committee need not be members of any professional body, such as the accounting profession, the attorneys profession or auditing profession. However, where a member of the audit committee is a member of a professional body, the committee would not only benefit from the expertise and experience but also from the relevant ethical and professional conduct expected from that member. This would enhance the independence of the individual members of the committee.

Crucially, Chapter 3 has demonstrated that the Companies Act 2008 and the PFMA do not make an express statement for the removal of members of the audit committee from that committee.[1026] Therefore, it is not clear as to who has the power to remove members of the audit committee under the Companies Act 2008. For the SOEs, the Treasury Regulations for PFMA make provision for the executive authority to agree with the accounting authority's premature removal of members of the audit committee.[1027] Though, it is unclear what should happen if the executive authority, with or without good cause, withholds concurrence with the premature removal of members of the audit committee, it may be presumed that the power to remove lies with the accounting authority. For privately-owned companies, this study found that the board of directors has, as it stands, the power to remove members of the audit committee.[1028] The board of directors' power to remove members of the audit committee is analogous to its power to appoint as contemplated in sections

[1024] Zábojníková G (2016) 9.
[1025] In terms of s 94(5) of the Companies Act 2008, read with Regulation 42 of the Companies Regulations 2011.
[1026] See the discussion in point 3.2.4 in Chapter 3 of this thesis.
[1027] Regulation 27.1.5 of the Treasury Regulation for PFMA.
[1028] See the discussion in point 3.2.4 in Chapter 3 of this thesis.

94(3)(b) and 94(6) of the Companies Act 2008. It was propounded in this study that the power of the boards of directors and accounting authorities to appoint and remove members of audit committees threatens the independence and effectiveness of these committees.[1029]

Chapter 3 of this thesis also outlines the critical role and functions of the audit committee. The study draws a distinction between statutory functions of the audit committee and those functions which may be assigned to the audit committee by the board of directors. For example, it is the statutory responsibility of the audit committee to determine audit fees and the auditor's terms of engagement as contemplated in section 94(7)(a) of the Companies Act 2008 but the board of directors may assign the governance, risk and compliance management oversight function to the audit committee in terms of section 94(7)(i) of the same Act. A key finding in this regard is that, because of the critical role and functions of the audit committee, the board of directors may develop the inclination to interfere with the functioning of that committee, thus eroding its independence.[1030]

6.2.4 Summary of Chapter 4 findings

This chapter dealt with the comparative analysis of the system of the audit committee. It detailed the genesis of the concept of the audit committee and how it has developed in jurisdictions like the UK and the USA over the years. The purpose of this comparison was to assess some international best practices relating to the independence of audit committees and highlight any lessons which South Africa could draw from the selected jurisdictions.

The comparison highlights a number of similarities and dissimilarities. As demonstrated in Chapter 4, the audit committees of UK companies are not legislated. They are prescribed in terms of that country's voluntary governance code.[1031] In contrast, it was shown in this chapter that the South African audit committees are legislatively regulated in terms of the Companies Act 2008 (and

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[1029] See the discussion in point 3.2.4 in Chapter 3 of this thesis. Also see the discussion in point 5.5 in Chapter 5 of this thesis.
[1030] See the discussion in point 3.4 in Chapter 3 of this thesis.
[1031] UK Governance Code (2018); Also see the discussion in point 4.2.2 in Chapter 4 of this thesis.

PFMA for the SOEs) and further recommended under the *King IV Code*.[1032] This is similar to the position in the USA under the SOX Act.[1033] The legislated regulation of audit committees under the Companies Act 2008 and the PFMA make such committees to enjoy a better measure of independence than the unlegislated audit committees under the UK's governance framework.[1034]

Significantly, it was highlighted that the shareholders of the UK and USA companies do not play any role in the establishment of audit committees and appointment of members thereto.[1035] The appointment and, by necessary inference, removal of members of the audit committee are the responsibilities of the board of directors in the UK[1036] and the USA.[1037] The reason for this could be the fact that both SOX Act in the USA[1038] and the UK governance code[1039] envisage the audit committee as a subcommittee of the board of directors. The UK governance code requires that the audit committee and its members be appointed by, be answerable and report to the board of directors.[1040] In South Africa, audit committees in private sector companies are appointed by the shareholders annually at the company's annual general meeting and by the board of directors in two specific instances.[1041] The position is slightly different under the PFMA, in that the audit committee in terms of that Act is established and staffed by the entity's accounting authority.[1042]

Another important distinction found in this comparative study is the fact that in both the UK[1043] and the USA,[1044] the audit committee is conceptualised as a committee

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[1032] See the discussion in point 4.4 in Chapter 4 of this thesis. Also see s 94 of the Companies Act 2008, Regulation 27 of the Treasury Regulation for PFMA and Principle 8 under Part 5.3 of the *King IV Code*.
[1033] Also see the discussion in point 4.3.2.2 in Chapter 4 of this thesis.
[1034] Also see the discussion in point 4.4 in Chapter 4 of this thesis.
[1035] Also see the discussions in point 4.2 and point 4.3 in Chapter 4 of this thesis.
[1036] Also see the discussion in point 4.2 in Chapter 4 of this thesis.
[1037] Also see the discussion in point 4.3 in Chapter 4 of this thesis.
[1038] See the definition of the audit committee in s 2(3) of Sarbanes Oxley Act of 2002. Also see s 301 of Sarbanes Oxley Act of 2002 and s 10A(m) of Securities Exchange Act of 1934.
[1039] Also see the discussion in point 4.2.3 in Chapter 4 of this thesis.
[1040] *Cadbury Report* (1992) para 4.35(a); *Smith Report* (2003) para 3.3; Guidance on Audit Committees (2016) paras 9 and 29; UK Governance Code (2018) para 24.
[1041] In terms of s 94(3)(b) and s 94(6) of the Companies Act 2008.
[1042] Regulation 27.1.1 of the Treasury Regulation for PFMA
[1043] *Cadbury Report* (1992) para 4.35(a); *Smith Report* (2003) para 3.3; Guidance on Audit Committees (2016) paras 9 and 29; UK Governance Code (2018) para 24.
[1044] See the definition of the audit committee in s 2(3) of Sarbanes Oxley Act of 2002. Also see s 301 of Sarbanes Oxley Act of 2002 and s 10A(m) of Securities Exchange Act of 1934.

or subcommittee of the board of directors. This position is not clearly set out in the Companies Act 2008. However, it has been demonstrated in this thesis that the audit committee under the Companies Act 2008 is not a committee or subcommittee of the board of directors.[1045] A committee which is appointed by and accountable to the board of directors is exposed to the risk of being controlled by that board. This has the effect of diminishing the independence and effectiveness of that committee.

The comparison highlights some common features relating to membership to audit committees in the UK and the USA on the one hand and South Africa on the other.[1046] The corporate governance regimes in both the UK and the USA require that the audit committees be staffed with non-executive directors of the company[1047]. A similar position is implicitly prescribed by the provisions of section 94(4) of the Companies Act 2008. This appears to be an attempt to establish some measure of independence for audit committees.

The evaluation of the independence of audit committees and protection thereof in the UK and the USA jurisdictions could not find any mechanisms which sufficiently safeguard the independence of audit committees. In this respect, the study could not find any key lessons which South Africa could draw from the UK and the USA. Through the involvement of the shareholders of the company in the appointment of members, South African audit committees appear to enjoy a better independence and protection.[1048]

6.2.5 Summary of Chapter 5 findings

Chapter 5 discussed various provisions of the Companies Act 2008 and the PFMA which have or could have the effect of improving or diminishing the independence of the audit committee in South Africa. In this regard, the following are the key highlights of the chapter.

On the provisions of the Companies Act 2008 which may strengthen the independence of South African audit committees, it was argued that the audit

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[1045] See point 2.3.1 in Chapter 2 of this thesis.
[1046] See the discussions in point 4.2.4 and point 4.3.4 in Chapter 4 of this thesis.
[1047] See the discussions in point 4.2.2 and point 4.3.2 in Chapter 4 of this thesis.
[1048] See the discussion in point 4.4 in Chapter 4 of this thesis.

committee which is regarded as a separate standalone committee of the company would enjoy a greater measure of independence than the audit committee which is characterised as a subcommittee of the board of directors.[1049] This argument is based on the proposition that the audit committee which is a standalone committee of the company would not be established and staffed by the board of directors, as is the case under the current scheme. Further, such committee would not be operating under the control of and not be accountable to the board of directors. It would be accountable to the company's shareholders in a meeting. It was further argued that the involvement of the shareholders of the company in the appointment of members to the audit committee in terms of sections 94(2) and 61(8)(c)(ii)) of the Companies Act 2008 should have the effect of enhancing the independence of the audit committee and thus, the protection of such independence. Another independence-enhancing mechanism is the express exclusion of certain persons from appointment as members of the audit committee as contemplated in section 94(4)(b) and (c)) of the Companies Act 2008. Under the PFMA, the study could not find any provisions which could have the effect of improving the independence of audit committees of the SOEs, except that the executive authority must agree with premature removal of members of the audit committee.[1050]

On the provisions of the Companies Act 2008 and the PFMA which have the effect of diminishing the independence of South African audit committees, it was argued that the audit committee which operates as a subcommittee of and whose members are appointed by the board of director is susceptible to full control of that board.[1051] Closely linked to this aspect is the fact that members of the audit committee are appointed from among members of the board of directors. In other words, and as argued in this chapter, the board of directors appoints itself on the audit committee to provide oversight on activities it has delegated to the management of the company and to report back to itself.[1052] Further, it was demonstrated in this study that, by virtue of its power to appoint, the board of directors has the power to remove members of the audit committee.[1053] This exposes the members of the audit

[1049] See the discussion in point 5.2.1.1 in Chapter 5 of this thesis.
[1050] See the discussion in point 5.4 in Chapter 5 of this thesis.
[1051] See the discussion in point 5.3.2.1 in Chapter 5 of this thesis.
[1052] See the discussion in point 5.3.2.3 in Chapter 5 of this thesis.
[1053] See the discussion in point 3.2.4.1 in Chapter 3 of this thesis.

committee to arbitrary removal, which threatens the independence of the individual members and the committee as a whole.

On the question of whether the director's independent judgment has the effect of promoting and protecting the independence of the audit committee as a whole, it was argued in Chapter 5 that this is doubtful.[1054] With the support of the authority of the *AmaBhungane Centre for Investigative Journalism NPC and Another* case, factors such as the manner of appointment and removal of members of the audit committee conduce to a perception of lack of independence of that committee, despite the fact that individual members are presumed to exercise independent judgment as directors.[1055] Further, this study demonstrated that the director's personal liability provisions in the Companies Act 2008 do not appear to deter directors, including members of the audit committee, from engaging in acts of dishonesty and conduct which has the effect of causing harm to the company.[1056] This aspect was argued with the support of the findings in the VBS Bank Report and the *Organisation Undoing Tax Abuse and Another v Myeni and Others* case, in which it was found that members of the audit committee acted in inappropriate and unlawful manner despite the fact that section 77 of the Companies Act 2008 was applicable to them as directors of the companies concerned.[1057]

6.3 RECOMMENDATIONS

As it has been demonstrated throughout this study, the audit committee is a critical corporate governance mechanism. An effective audit committee can help to improve the integrity and quality of financial reporting and reduce the risk of financial irregularities and fraudulent activities. It can also aid to enhance the auditor's independence,[1058] enforce regulatory and legislative compliance and promote sound corporate governance for the benefit of the community of stakeholders.[1059] It

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[1054] See the discussion in point 5.5 in Chapter 5 of this thesis.
[1055] See the discussion in point 5.5 in Chapter 5 of this thesis. Also see the discussion in point 5.2 in Chapter 5 of this thesis, where the term 'independence' within the context of an independent body such as the audit committee is discussed.
[1056] See the discussion in point 5.6 in Chapter 5 of this thesis.
[1057] See the discussion in point 5.6 in Chapter 5 of this thesis.
[1058] As contemplated in s 94(7)(a) and s 94(8) of the Companies Act 2008.
[1059] See the discussion in point 1.3 in Chapter 1 of this thesis.

was argued throughout this study that there is a need for audit committees to be independent and that such independence should be sufficiently protected.

This study has also showed the connection between the independence of the audit committee and protection thereof on the one hand and the appointment and removal of members from that committee on the other hand. In this regard, a simple insider-outsider dichotomisation[1060] of directors is inadequate.[1061] In other words, it is not sufficient that South African audit committee must be staffed with 'outside' directors (the independent non-executive directors) as contemplated in section 94(4) of the Companies Act 2008. It was demonstrated in this thesis that it makes little difference that members of the audit committee are executive or non-executive directors of the company.[1062]

The following recommended legislative amendments, particularly section 94 of the Companies Act and the section 77 of the PFMA (and its Treasury Regulations), may assist to enhance and fully protect the independence of the company's audit committee for privately-owned companies, SOCs and SOEs:

6.3.1 Amendment of section 94(2) of the Companies Act 2008

First and foremost, it is recommended that this section of the Companies Act 2008 should be amended to expressly state that the audit committee established in terms of that section is an independent 'standalone committee' of the company appointed by and accountable to the company's shareholders in a shareholders' meeting. This section should also state that, as a 'standalone committee', the audit committee must be established and its members be appointed only through a shareholders' annual general meeting and must be accountable to the shareholders acting through a duly constituted shareholders meeting.

[1060] Dichotomisation in the sense of the contrast between executive directors and the non-executive directors of the company, where non-executive directors are said to be independent and not involved in the day to day management of the company.

[1061] DeZoort FT et al 'Audit Committee Effectiveness: A Synthesis of the Empirical Audit Committee Literature' (2002) vol 2 *Journal of Accounting Literature* 43.

[1062] See the discussions in point 2.2.2.1 in Chapter 2 and point 5.3.2.2 in Chapter 5 of this thesis.

6.3.2 Amendment of section 94(3) of the Companies Act 2008

The Companies Act 2008 should not make provision for appointment of the first members of the company's audit committee by the company's incorporators or by the board of directors. Instead, section 94(3) should be amended, so as to make provision for members of the audit committee to be elected and appointed by shareholders, at a special shareholders meeting, within the 40 business days from the date of incorporation. This would be consistent with the idea that audit committees are established and appointed at the annual general meeting of the company's shareholders as contemplated in section 94(2) of the Companies Act 2008. This would address any urgency to establish the audit committee before the company's first annual general meeting.

6.3.3 Amendment of section 94(4)(a) of the Companies Act 2008

For the purpose of directors' statutory duties[1063] and directors' liability,[1064] a member of the company's audit committee is regarded as a director of that company. Therefore, there is no need for a provision under section 94 of the Companies Act 2008 for a member of the audit committee to be a director of the company if the legislative intention is to hold members of the audit committee to account as contemplated in sections 76 and 77 of the same Act. What needs to be prescribed is that a member of the audit committee should not be a member of the company's board of directors.

Importantly, it is recommended that Section 94(4)(a) should also be amended to prohibit, from serving as member of the audit committee, anyone who is the current member of the board of directors or former member of the board of directors whose directorship ended within the preceding three financial years or any other person who is related to the current or former member of the board of directors whose board directorship ended within the preceding three financial years. This could minimise or reduce the likelihood of the board of directors'

[1063] See s 76(1)(b) of the Companies Act 2008.
[1064] See s 77(1)(b) of the Companies Act 2008.

interference with the functioning of the audit committee and enhance the committee's independence.

6.3.4 Amendment of section 94(4)(b)(ii) of the Companies Act 2008

This section should be amended to include any type of employee and not only full-time employees. The reason for this is that temporary employees, fixed term employees, freelance employees and independent contractors who do not necessarily provide services to the company or its related or inter-related company on the full time basis, could equally have direct or indirect undue influence on or directly or indirectly be unduly influenced by the management or the governing body of the company or its related or inter-related company.

To make section 94 of the Companies Act 2008 clearer, the term 'employee' should be defined in and for the purpose of that section and such definition should cover the types of employees mentioned above.

6.3.5 Amendment of section 94(6) of the Companies Act 2008

This subsection should be amended to strip the board of directors off the powers to appoint members of the audit committee to fill a vacancy in the committee. The audit committee members should be elected and appointed by shareholders, at a special shareholders meeting, within the 40 business days after the vacancy has arisen.

6.3.6 Amendment of section 94(10) of the Companies Act 2008

Section 94(10) of the Companies Act 2008 should be amended or deleted in its entirety. The Companies Act 2008 should empower the audit committee to discharge its statutory functions and duties only subject to that Act, its regulations and the company's Memorandum of Incorporation. This section should be amended or be replaced with the provision that the audit committee is appointed by and only accountable to the company's shareholders in a meeting. In its current form, section 94(10) of the Companies Act 2008 appears to give the board

of directors the power to interfere with the work (and the independence) of the audit committee, except with respect to the appointment, fees and terms of engagement of the auditor.

6.3.7 Insertion of new subsection under section 94 of the Companies Act 2008 to regulate removal of members of the audit committee

It has been demonstrated in this thesis that, by virtue of its power to appoint, the board of directors has the power to dismiss or remove members of the audit committee from that committee.[1065] This may even happen in circumstances where the intention of the board of directors is to remove a member of the board of directors from the audit committee without necessarily removing such member from the board of directors.

It is recommended that a new subsection should be inserted under section 94 of the Companies Act 2008 to make an express provision on how members of the audit committee may be removed from that committee before expiration of their term of office. Importantly, the recommended subsection should protect the independence of members of the audit committee and the committee as a whole by prescribing that the members of the audit committee may be removed or dismissed from that committee only by shareholders in a duly constituted special meeting.

6.3.8 Insertion of new subsection under section 94 of the Companies Act 2008 to maintain the prescribed minimum number of members on the audit committee during suspensions or recusals

There may be instances where a member of the audit committee has been suspended or has recused himself or herself by reason of conflict of interests or any other reason, on a particular matter under the consideration of the audit committee. For the purpose of the aforementioned, section 94 of the Companies Act 2008 should be amended to make provision for the appointment of temporary

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[1065] See the discussion in point 3.2.4.1 of Chapter 3 of this thesis.

replacement members of the audit committee to keep the number of members of the audit committee at the prescribed minimum level. This would ensure that the audit committee remains adequately staffed at all times and to safeguard and maintain its independence and effectiveness.

6.3.9 Regulation 42 of the Companies Regulation 2011

Section 94(5) of the Companies Act 2008 empowers the Minister to regulate the minimum qualification requirements for members of the audit committee. Regulation 42 of the Companies Regulations 2011 prescribes that at least one-third of the members of the company's audit committee must, at any given time, have academic qualifications or experience in the field of economics, law, corporate governance, finance, accounting, commerce, industry, public affairs or human resources management.

To improve the effectiveness and independence of the audit committee, it is recommended that Regulation 42 of the Companies Regulations 2011 should be amended to prescribe that all members of the audit committee must meet the set minimum academic qualification requirements. This would ensure that audit committees of both privately-owned companies and public entities are staffed with members who are suitably and adequately qualified and experienced to discharge the functions of the committee independently and without fear or favour.

6.3.10 Amendment of section 77 of the Public Finance Management Act 1999 and the relevant regulations

The PFMA empowers the National Treasury to make regulations in respect of the appointment and functioning of audit committees of institutions to which that Act applies.[1066] It was shown in this study that the PFMA applies to public entities including SOEs.[1067] Except for the prescribed minimum number of persons to be

[1066] S 76(4)(d) the Public Finance Management Act 1 of 1999.
[1067] See the discussion in points 1.1.3.1 and 1.1.3.3 of Chapter 1 of this thesis.

appointed to the audit committee, section 77 of the PFMA does not set out any provisions which deal with the appointment (and removal) of members of the audit committee and the functions of that committee. This is regulated in terms of the Treasury Regulations issued by the National Treasury.

It is recommended that section 77 of the PFMA should be amended to make provision for the establishment of audit committees of public entities as standalone committees of the entity. This would cause the necessary amendment of Regulation 27.1.1 of the Treasury Regulations for PFMA to the effect that audit committees of SOEs are not regarded as subcommittees of those entities.

The PFMA should further make an express statement prescribing that the appointment and removal of members of audit committees of national and provincial SOEs shall be the responsibility of and carried out by the relevant National or Provincial Minister under whose department the entity falls. This would cause the necessary amendment of Regulation 27.1.4 of the Treasury Regulations for PFMA, which currently empowers the accounting authority to establish the audit committee and appoint members thereto. It is recommended that the audit committees of the SOEs should only account to the Standing Committee On Public Accounts at the relevant government sphere. This would enhance and promote the independence of members of audit committees in the SOEs.

It is further recommended that the PFMA (and its regulations) should be amended to prohibit from being appointed as a member of the audit committee, any current or former executive or non-executive member of the entity's accounting authority whose directorship ended within the preceding three financial years or any person who is related or inter-related to such current or former executive or non-executive member. This prohibition should also be extended to any employee, independent or freelance consultant, customer or supplier of the entity whose relationship ended within the preceding three financial years or any person who is related or inter-related to such employee, independent or freelance consultant, customer or supplier of the entity. This would cause the necessary amendment of Regulation 27.1.4 of the Treasury Regulations for PFMA, which currently appears to allow for the appointment of anyone to the audit committee of the public entity.

6.4 FINAL REMARKS

The Companies Act 2008 is generally good law. It is a product of the policy aspirations of the government's policy paper,[1068] whose objective is to, among others, encourage transparency and sound corporate governance within South African companies.[1069] This objective is firmly entrenched in Chapter 3 of the Companies Act 2008, which sets out provisions which deal with audit committees, among others.

The corporate governance failures and financial irregularities scandals in South African private sector corporations and major public entities happened despite the existence of audit committees in these corporations.[1070] As pointed out throughout this thesis, this raises doubts as to the effectiveness of these audit committees, as well as the independence of individual members of that committee and the committee as a whole. However, this expression should not be mistaken to mean that effective and independent audit committees could have prevented corporate governance collapses and financial irregularities in these companies. Instead, the intention of this argument is to highlight the fact that effective and independent audit committees could have helped improve transparency, accountability and integrity in South African companies as contemplated in government's policy paper of 2004 and as adopted in Chapter 3 of the Companies Act 2008. This triplex of transparency, accountability and integrity is currently lacking.

One of the aims of this thesis was to aid the conceptualisation of the audit committee as an important governance instrument in the promotion of transparency and accountability within the corporate structures of South African companies. This study further aimed to contribute to the development of jurisprudence in corporate governance and to make an original contribution to the growth of the general body of knowledge in the domain of corporate law. It is hoped that this study has achieved

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[1068] South African Company Law for the 21st Century, Guidelines for Corporate Law Reform (GN 1183 in GG 26493 of 23 June 2004).

[1069] South African Company Law for the 21st Century, Guidelines for Corporate Law Reform (GN 1183 in GG 26493 of 23 June 2004) 9.

[1070] See the discussion in point 1.1 of Chapter 1 of this thesis.

this objective and that it has further generated an interest for a similar study for government departments and municipalities.

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