UNIVERSITY OF THE WESTERN CAPE
FACULTY OF LAW

FINAL MASTERS THESIS

A MINI-THESIS SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE OF M. PHIL: LABOUR LAW IN THE DEPARTMENT OF MERCANTILE AND LABOUR LAW, UNIVERSITY OF THE WESTERN CAPE.

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Degree: M. PHIL

Department: DEPARTMENT OF MERCANTILE & LABOUR LAW

Title of Study: Combating financial misconduct by ensuring the implementation of a financial literacy requirement for directors and audit committee members

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Date: 10 December 2021

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PLAGIARISM DECLARATION

I declare that *'Combating financial misconduct by, ensuring the implementation of a financial literacy requirement for directors and audit committee members'* is my own work, that it has not been submitted before for any degree or examination in any other university, and that all the sources I have used or quoted have been indicated and acknowledged as complete references.

Signed …… *Brittany Ann Goldberg*……….. Dated……10 December 2021…

Prof R Wandrag Dated 10 December 2021

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KEYWORDS

- Corporate Governance
- Business Ethics
- Financial Misconduct
- Financial Literacy
- Companies Act 71 of 2008
- Board of Directors
- Audit Committee
- Shareholders
- Stakeholders
- King Code IV
- Johannesburg Stock Exchange
- Common Law

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ACKNOWLEDGEMENTS

I wish to thank all my family and friends who played a role in the successful completion of my studies. I would like to extend a special word of appreciation to the following people:

- First and foremost, I would like to praise and thank God, the Almighty, who has granted me countless blessing, knowledge, and opportunities.

- I am extremely grateful and thankful to my supervisor, Professor R. Wandrag for her invaluable advice, continuous support, and patience during my LLM studies. Her immense knowledge and plentiful experience encouraged me throughout my thesis.

- I am deeply grateful to Professor J. Papier for her support and encouragement throughout my tertiary education.

- I am forever indebted to my parents, Ann and Sydney, for giving me the opportunities and experiences that have made me who I am and for their continuous and unparalleled love, help and support.

- My gratitude and thanks to my brother, Jade, for always being there for me and supporting me no matter the circumstances.

- To Uncle Bernie, Bronwyn, Deidre, Marius, Brandon and children (Darius, Mandré, Mené and Blake), there will never be words to express how grateful and thankful I am for everything you have done for me.

- To Chloe and Vashti, thank you for constant support. You are true and special friends that I will forever be grateful for.

- Finally, I would like to thank my husband, Tashreeq. Thank you for your unconditional support and love. You have kept me sane and have been there for me throughout, always encouraging me to push myself. I owe you more than words and actions can ever show: thank you for being the person you are. A special thanks to your family, Aunty Shamiela, Raees and Shakeel, who have beaker of encouragement and support.

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DEDICATION

I would like to dedicate this thesis to my mother, whose example has taught me to work hard for the things that I aspire to achieve. Throughout my life, you have actively supported me in my determination to realise my potential. My love and appreciation for you all can never be quantified.

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1. Chapter 1: Introduction

1.1. Problem statement

Before the 1990s, corporate governance was a very rarely used term within the business world.[1] Corporations over time have become more influential, larger and more complex within the global economy; therefore to ensure that they are operating on an economic and ethical basis, corporate governance has become more defined.[2] Corporate governance can be defined as the procedures and methods that are used in order to ensure the functioning, direction and structure of a corporation.[3] Not only can its key elements be described as procedures and methods but also a system of principles, policies, procedures, and clearly defined responsibilities and accountabilities. Corporate governance has roots in ethical behavior and business principles, with the goal of creating long-term value and sustainability for all stakeholders, thus including directors.[4] This practice of good corporate governance by directors is used to promote equity and deters fraud and other deceptive practices.[5]

Therefore, due to highly publicized global and local corporate failures over a number of years, increasing importance has been placed on how to deal with directors who do not fulfil their duties in terms of the law and/or or who do not adhere to the standard of conduct expected of a director.[6] This has also resulted in calls to re-emphasize the understanding of the important roles that companies play in the economy and the key responsibilities of directors to ensure oversight of

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[1] Mongalo T 'The Emergence of Corporate Governance as a Fundamental Research Topic in South Africa' (2003) *South African Law Journal* pg.174.
[2] Clarke T 'OpenMind BBVA: Ethics, Values and Corporate Governance' available at *https://www.bbvaopenmind.com/en/articles/ethics-values-and-corporate-governance/* (accessed on 19 May 2020).
[3] McRitchie J 'Corporate Governance Defined: Not So Easily' available at *https://www.corpgov.net/library/corporate-governance-defined/* (accessed on 20 November 2020).
[4] Price N 'The Role of the Board of Directors in Corporate Governance' available at *https://insights.diligent.com/corporate-governance/the-role-of-the-board-of-directors-in-corporate-governance* (accessed 20 May 2020).
[5] Price N 'The Role of the Board of Directors in Corporate Governance' available at *https://insights.diligent.com/corporate-governance/the-role-of-the-board-of-directors-in-corporate-governance* (accessed 20 May 2020).
[6] Institute of Directors South Africa 'Director Misconduct: General guidance note on how to approach director misconduct' available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/IoDSA_Guidance_for_Boards_-_Director_Misconduct.pdf* (accessed on 4 August 2021).

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companies.[7] With the focus on financial reporting (which is a duty held by the board of directors and audit committee members), a question can then be asked as to whether ensuring the financial literacy of audit committee members and the board of directors by means of legislation will help with the promotion of good corporate governance.

In many corporations directors or audit committee members who do not have the suitable financial literacy are being appointed in the required positions.[8] The rise of financial misconduct has been growing steadily. South Africa has had its fair share of corruption. Though there is legislation in place to ensure good corporate governance, this is not always the case. It is noted that one cannot determine or inflict ethically behavior on the next person; this also goes to say that we cannot measure how ethical a person should or should not be. Yet when looking in the business sphere, it is easy to state what a company should and should not be doing. This is not only for privately owned companies but also is true for state-owned companies. Business ethics can be a force that helps drive corporate governance; they have been spoken together in the past and it seems to be that they are more relevant. With the growth of corporations that have become more influential, larger and more complex within the global economy, it is therefore important to ensure that they are operating on an economic and ethical basis.

In South Africa, market abuse has always been a problem; legislation such as the Companies Act,[9] the Financial Markets Control Act[10] and the Stock Exchange Control Act[11] all show the early attempts that the South African took in order to combat negative market practices within the financial market.[12] These were not successful and resulted in failure to ensure that market abuse was properly regulated. IOL has reported the eThekwini Municipality is under investigation;[13] this

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[7] Institute of Directors South Africa 'Director Misconduct: General guidance note on how to approach director misconduct' available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/IoDSA_Guidance_for_Boards_-_Director_Misconduct.pdf* (accessed on 4 August 2021).
[8] Leblanc R *The Handbook of Board Governance: A Comprehensive Guide for Public, Private, and Not-for-Profit Board Members* 2ed (2020) ch. 28.
[9] Companies Act 61 of 1973.
[10] Financial Markets Control Act 55 of 1989.
[11] Stock Exchange Control Act 1 of 1985.
[12] Chitimira H 'A Historical Overview of the Regulation of Market Abuse in South Africa' (2014) 17 *Potchefstroom Electronic Law Journal* pg. 937.
[13] Comins L 'Report finds city wasted millions in financial misconduct, flawed HR processes' available at *https://www.iol.co.za/mercury/news/report-finds-city-wasted-millions-in-financial-misconduct-flawed-hr-processes-44420441* (accessed on 30 March 2020).

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includes the investigations of as many as 300 members of staff, including senior managers, with allegations ranging from negligence related to the wrongful hiring of staff and financial misconduct, which has resulted in hundreds of millions rands in unauthorized and irregular expenditure cost to the city.[14] Another current example can be seen in the firing of CEO of the Airports Company SA (Acsa), Bongani Maseko. He was implicated in several forensic investigations for alleged financial misconduct.[15]

A prime example of financial misconduct spread can be seen in the Steinhoff case, where a group of executives' earnings and asset values were exaggerated.[16] This resulted in many adverse effects for the company, which included the realization that any previous audited results of Steinhoff 'meant nothing'; even though they were signed off, they could not show a true representation of the factual situation that was faced at the company.[17] The question asked is: What is the appropriate way to deal with directors or audit committee members who fraudulently misrepresent the financial statements of a company? Not much literature has been written on this and therefore exploring different ideas can help address this.

Directors or audit committee members do not always come from financial backgrounds. Due to there being no fixed criteria for appointments of directors (no legal criteria), it is usually left to the companies to make this determination during appointment. Under common law, a candidate when applying for a director position should act with the proper care, skill and diligence,[18] or should consider the reasonable person test. This can be seen under section 76(3) of the Companies Act.[19] This can also be seen under Chapter VIII; Code of Conduct for Regulated Persons,[20] Section 74

[14] Comins L 'Report finds city wasted millions in financial misconduct, flawed HR processes' available at *https://www.iol.co.za/mercury/news/report-finds-city-wasted-millions-in-financial-misconduct-flawed-hr-processes-44420441* (accessed on 30 March 2020).

[15] Mahlaka R 'Acsa counts the cost of former CEO's financial misconduct' available at *https://www.dailymaverick.co.za/article/2019-11-10-acsa-counts-the-cost-of-former-ceos-financial-misconduct/* (accessed on 30 March 2020).

[16] Fin24 **'**Steinhoff wants Markus Jooste to pay back R870m**'** available at *https://www.fin24.com/Companies/steinhoff-wants-markus-jooste-to-pay-back-r870m-financial-mail-20190626* **(**accessed on 30 March 2020**)**.

[17] Fin24 **'**Steinhoff wants Markus Jooste to pay back R870m**'** available at *https://www.fin24.com/Companies/steinhoff-wants-markus-jooste-to-pay-back-r870m-financial-mail-20190626* **(**accessed on 30 March 2020**)**.

[18] Section 76(3) of the Companies Act 71 of 2008.

[19] Act 71 of 2008.

[20] Financial Markets Act 19 of 2012.

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which regulates how a person should conduct themselves. It sets out a general code of conduct that applies to all person who are regulated under the Financial Markets Act[21] and ensures they act with the appropriate manner, most importantly with honestly, fairly and with due skill, care and diligence, thus prohibiting market abuse. As with Directors there are prescribed requirements for audit committee members. These can be found in either common law e.g. King Code IV, the Companies Act 71 of 2008 (section 94) or the Banks Act (section 64).[22]

'Having appropriate and relevant skills on the audit committee is increasingly important';[23] yet each member of the audit committee does not necessarily need to have the financial literacy. As a collective, King Code IV requires that, the audit committee have the necessary skill and experience to meet its obligations.[24] The Companies Act 71 of 2008 (hereafter known as the Companies Act) goes further and states that at least one-third of the members of the 'audit committee [should] have academic qualifications, or experience in economics, law, corporate governance, finance, accounting, commerce, industry, public affairs or human resource management'.[25] This then leaves space for financial misconduct.

Corporate governance aims to ensure that companies, whether they are private or public, function with clearly defined responsibilities and are able to hold people accountable for their actions, such as when they have committed financial misconduct.[26] In order to maintain good corporate governance and business ethics, a company needs to operate at optical conditions and ensure that it meets all the required steps set out by legislation and maintains a good public face. Ensuring that those who deal with financial statements are financially literate is a key part of this.

In regard to those who do not have financial backgrounds, yet are employed in positions where they deal with company's financial records, what responsibility falls on the company to ensure

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[21] Act 19 of 2012.
[22] Act 94 of 1990.
[23]Delottie. 'The Audit Committee Report: Analysing the trends in South Africa' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/audit/za_Deloitte_The_Audit_Committee_Report_240418.pdf* (accessed on 21 September 2021).
[24] Deloitte. 'Audit Committee Resource Guide' available at *https://www2.deloitte.com/za/en/pages/audit/articles/audit-committee-resource-guide.html* (accessed on 21 September 2021).
[25] Deloitte. 'Audit Committee Resource Guide' available at *https://www2.deloitte.com/za/en/pages/audit/articles/audit-committee-resource-guide.html* (accessed on 21 September 2021).
[26] Wiese T *Corporate Governance in South Africa with International Comparisons* (2014) pg. 7.

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that there is financial literacy present to ensure that financial misconduct is prevented? What regulatory measure can be put in place to ensure that this is manageable? This brings into question whether there should be a criterion in law as to who can be appointed in positions that require this financial management.

1.2. Significance of the problem

Not much research has been conducted around this area, specifically when looking at companies and who is responsible to ensure that financial literacy is taught and maintained. The significance of this problem is that no legislation is put in place when looking at whether a director, for example, should be financially literate, even though they work with financial statements. Valuable insight can be gained in order to determine how these concepts relate to one another within South Africa's legislation and business sector. Though financial misconduct is regulated within South Africa and is dealt with under legislation, how should it be regulated when someone who has no financial literacy commits it?

It will thus help determine whether a change in legislation needs to occur to ensure not only that financial literacy is maintained but that this is regulated and maintained. Exploring the appointment of the individuals such as directors, where there are no regulation/requirements on who may be a director, is also an important aspect. Once this is done, then it is simpler to determine what cause of actions should be taken against those who do not have any financial literacy but are found guilty of financial inconsistencies. This study will give a better perspective on what is needed to ensure that this is a level that is maintained across all companies (whether private or public) and in South Africa's business economy.

1.3. Research question

To what extend would the implementation of a financial literacy requirement on the board of directors and audit committees not only ensure good corporate governance and business ethics but also combat financial misconduct?

1.4. Aims of the research

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The first aim of this thesis will be to explore the relationship between business ethics and corporate governance. By determining this relationship, it will help establish what is considered appropriate behaviour of both directors and audit committee members.

The second aim is exploring the importance of financial literacy. This is vital, as it will set the tone of the entire paper by looking at what legislation requirements mention financial literacy, including what is mentioned in common law. The relationship between business ethics, corporate governance, and financial literacy will be determined to show its importance.

The third aim is to explore of the role of the board of directors in a company and the importance of the director's duty in financial aspect of the company. This will also explore who should be responsible to ensure that directors have the necessary financial literacy skills requirement. A related aim is to look at the importance of having undisputed requirements for the appointment of directors within legalisation.

The fourth aim, similar to aim three, is examining the role of the audit committee, looking not only at the requirements around the appointment of the audit committee but also the requirements placed on the importance of financial literacy, thereby determining whether amendments should include ensuring that all members should have the financial literacy.

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The fifth aim will establish if amendments to South Africa's legislation should take place. This will go hand in hand with those appointed and what requirements are looked at when those who deal with financial statements are appointed. This will thus ensure that a proper standard is kept throughout all the companies in South Africa, ensuring better regulations and standards for all public and private companies. Comparing this to an international standard and how it is dealt with on that scale will also be done so as to assess the progress of South African legislation.

1.5. Proposed chapter outline

1.5.1. Chapter 1: Background

This chapter sets out the background for this study. It focused on the problem that I have identified regarding financial literacy. It gave a clear direction on what I want to achieve and what other topics will be discussed.

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1.5.2. Chapter 2: Financial Misconduct, Corporate Governance and Business Ethics

Within this chapter, financial misconduct, corporate governance and business ethics will be explored – not only how these terms are regulated separately but also how they play a role together. This will be done under either one or both piece of legislation (Companies Act 71 of 2008 and King Code IV) and the MOI. Establishing what is a financial misconduct is vitally important. I will then explore the link between the aspect of financial literacy and business ethics and corporate governance, showing how this can be used to combat financial misconduct through financial literacy. Whose duty is it to ensure that both corporate governance and business ethics are carried out and to what extent it is done will be examined. Once these concepts are established and better understood, I will look at their role in helping to combat financial misconduct. This will be done by looking at how the concepts of corporate governance and business ethics can be used to promote the financial literacy of the board of directors and audit committee members.

1.5.3. Chapter 3: Board of Directors

This chapter will examine the role the board of directors in a company. It will focus on the financial duties that the board has. I will look at how directors are appointed and the criteria used during their appointment, with the focus being on s 77 of the Companies Act 71 of 2008. Once proper requirements are established, the importance of financial literacy of directors will be examined, using this information to show how directors can combat financial misconduct from their standpoint. This relationship can be explored in more detail with corporate governance and business ethics. This is not only to determine the importance of directors being financial literate but also to understand how directors can play an important role in combating financial misconduct. The business judgment rule will also be looked at in this chapter, and its position during financial misconduct. The aim is to establish how other countries deal with both financial literacy of the board of directors and see if there is any legislation or regulation that govern this, which will help determine how standards differ and what suggestions can be made to improve standards in South Africa.

1.5.4. Chapter 4: Audit Committee

The role of the audit committee will be explored. This chapter will not only at look how the committee is appointed but what the requirements are for these appointments. As one of the

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committee's key functions is to deal with the financial matters that the board is not able to look at (due to time), the importance of the element of financial literacy will be explored. Ensuring that all members of the audit committee are financially literate will not only help combat financial misconduct but also promote good corporate governance and business ethics of the company. I will also use the Johannesburg Stock Exchange (hereafter known as the JSE) listing requirements as a guide for the requirements as to the financial literacy of audit committee members. As with the previous chapter, I will explore the international legislation and regulations that are in place in different countries to implement the financial literacy of the audit committee.

Chapter 5: Conclusion

This chapter will state the most important aspects from the previous chapters, including the importance of corporate governance and business ethics in a successful company, how the impact of financial misconduct can be detrimental to the success of the company, and the importance of financial literacy. It will further highlight the important roles that both the board of directors and audit committee members play within the company, with emphasis on the importance of financial literacy of the board of directors and audit committee members. Finally, I will give my opinion and recommendations on the importance of financial literacy for combating financial misconduct.

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1.6. Research Methodology

The research will be conducted by analysing the relevant South African legislation and case law regarding business ethics, corporate governance, financial misconduct and finally financial literacy. The main legislative framework that will be looked at will be the Common Law, the Constitution,[27] the Companies Act, JSE and King Code IV. Financial misconduct and financial literacy will be looked at on an international level as well.

[27] Act 108 of 1996.

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2. Chapter 2: Financial Misconduct, Corporate Governance and Business Ethics

2.1. Introduction

This chapter will deal with financial misconduct, financial literacy, corporate governance, and business ethics. These terms are important in determining the roles and expected behaviour of the board of directors and audit committee members. By exploring these terms, I will be able to find the link between corporate governance, business ethics and financial literacy and its importance in combating financial misconduct. This chapter will further establish whose duty is it to ensure that both corporate governance and business ethics are carried out and see to what extent this is done. Exploring the definition of financial literacy is also important, as it will set the tone for the rest of the chapters. This will be done by examining how the concepts of corporate governance and business ethics can be used to promote the financial literacy of directors and audit committee members.

2.2. Corporate Governance

Ensuring that we are better corporate citizens and that we can maintain good corporate governance is vital. This is important not only when looking at the growth of a company and its public image but also in ensuring that a company holds itself accountable to an appropriate standard. This allows companies to put their positive traits on display and make their intentions as a company known.[28] Companies can be held accountable for their conduct and activities, and so are eager to distance themselves from dishonesty.[29] With the numerous environmental threats that South Africa faces, including climate change, water scarcity, lethal air pollution and large-scale destruction of our natural heritage, it is important for companies to display good traits.[30] I will therefore explore the concept of corporate governance, its history and relevant legislations (such as the Companies Act, Public Finance and Management Act 1 of 1999, Johannesburg Stock Exchange and King Code) and

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[28] McRitchie J 'Corporate Governance Defined: Not So Easily' available at *https://www.corpgov.net/library/corporate-governance-defined/* (accessed on 20 November 2020).
[29] McRitchie J 'Corporate Governance Defined: Not So Easily' available at *https://www.corpgov.net/library/corporate-governance-defined/* (accessed on 20 November 2020).
[30] Davies T 'SA's corporates must wake up to social and environmental roles' available at *https://www.businesslive.co.za/bd/opinion/2018-02-23-sas-corporates-must-wake-up-to-social-and-environmental-roles/* (accessed 28 November 2020).

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its importance for the better standing of companies. Once I have explored this concept, I will be able to show the importance of corporate governance in combating financial misconduct.

2.2.1. **History**

When corporate governance first came into existence, its implementation differed to what we find today. Ownership of the company is separate from control, which means that the management responsibility falls within the scope of the directors, and owners do not have much say in that area.[31] Nowadays the need to ensure that stakeholders and directors are on the same footing is important so that the management of a company can be more transparent.

The concept of corporate governance was not used very often[32] but this does not mean that it did not exist. As early as 1844, this term was used in the United Kingdom in the introduction of the Joint-Stock Companies Act.[33] This helped lay the foundation of what we have now established the modern definition of corporate governance to be; this can be attributed to the fact that the United Kingdom colonized most of the world. By 1970s through to the 1990s, corporate governance was well-entrenched in both academic writing and regulatory shorthand;[34] this included the United Kingdom as well as the United States, Germany and developing countries like Brazil and China.[35]

Another historical event that saw the rise of the importance of ensuring corporate governance was the East Asian crisis of the late 1990s. This started in Thailand when the government decided to no longer peg the local currency to the U.S. dollar, which resulted in the decline of currency throughout Asia.[36] This underlined the importance of a country having good corporate governance structures so as to ensure the efficiency and growth of the domestic economy.

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[31] Kondlo N. *The Importance of Corporate Governance in South African Family-Owned Companies: Effects of Ownership and Board Composition on Performance* (Master in Mercantile Law, University of the Western Cape, 2016) pg. 7.
[32] Mongalo T 'The Emergence of Corporate Governance as a Fundamental Research Topic in South Africa' (2003) *South African Law Journal* pg. 174.
[33] Wiese T 'Corporate Governance in South Africa with International Comparisons' 2ed (2014) pg. 3.
[34] Cheffins, Brian R. (2001) 'The History of Corporate Governance' University of Cambridge Faculty of Law Research Paper No. 54/2011 pg. 1.
[35] Wiese T 'Corporate Governance in South Africa with International Comparisons' 2ed (2014) pg. 5.
[36] Scott G 'Asian Financial Crisis' available at *https://www.investopedia.com/terms/a/asian-financial-crisis.asp* (accessed on 1 January 2021).

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Corporations have become more influential, larger and more complex within the global economy, highlighting the need to ensure that they are operating on an economic and ethical basis. The notion of corporate governance has thus grown in importance over the years.

2.2.2. **Definition and role-payers**.

As previously mentioned, the term corporate governance is very board. Though most definition follow a similar understanding, they do differ from each other, as seen below.

- According to one source, corporate governance is defined as the balance of authority among management, shareholders, and boards of directors.[37] This ensures that all standards are transparent and in line with international requirements, that the board and auditors are independent, and that the shareholders are all treated equally.[38]

- The Charted Governance Institution (ICSA) defines corporate governance as a company's purposes and the way it is run; this includes all aspects such as its organisation, communication, leadership and strategic decision-making. This mainly involves the board of directors and their functions.[39]

- Another group of authors defines corporate governance as the way firms are governed and managed.[40]

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By displaying their positive traits, companies allow their intentions to be made visible and therefore they are more likely to be accountable for their behaviour and actions.[41] Corporate governance, in my understanding, therefore refers to rules and principles that place a responsibility on companies to refrain from prohibited activities and display their positive traits.

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[37] MBA Lectures 'Importance of Corporate Governance' available at *https://mba-lectures.com/others/1425/importance-of-corporate-governance.html* (accessed on 1 January 2021).
[38] MBA Lectures 'Importance of Corporate Governance' available at *https://mba-lectures.com/others/1425/importance-of-corporate-governance.html* (accessed on 1 January 2021).
[39] Price N 'Importance of Corporate Governance in an Organization' available at *https://insights.diligent.com/corporate-governance/importance-of-corporate-governance-in-an-organization* (accessed on 20 November 2020).
[40] du Plessis J, Hargovan A, Bagaric M *Principles of Contemporary Corporate Governance* 2ed (2011) Cambridge University Press (2011) pg. xxv.
[41] Price N 'Importance of Corporate Governance in an Organization' available at *https://insights.diligent.com/corporate-governance/importance-of-corporate-governance-in-an-organization* accessed on (20 November 2020).

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2.2.2.1. **Board of Directors**

The board of directors is there to establish corporate values and effective governance structures for the company, both on an individual and group basis. The board of directors is the link between the shareholders and management and is there to help drive the implementation of good corporate governance.[42] Their main responsibilities are to establish corporate values and governance structures for the company, establish long-term strategic objectives for the company, ensure that management has supplied the board with sufficient information for it to be fully informed and prepared to make the decisions that are its responsibility, and adequately monitor and oversee the company's management.[43] Success or failure of a corporation depends largely on the choices of the board of directors; thus they are the most important role-players when it comes to corporate governance as.[44]

2.2.2.2. **Shareholders**

Shareholders are those individuals or companies who have bought shares within a corporation. They entrust management with funds from reinvested earnings or newly issued stock. Shareholders appoint a board of directors to ensure that the directors can run the business and perform adequately so that the corporation is a success.[45] Another way to look at this is via Agency Theory, which discusses those who are hired by the company's shareholders, who are also the owners or principals. The directors or managers, who are the shareholders' agents, entrust business management to the principals,[46] and also ensure that the shareholders gain a profit from their investments. Corporate

[42] Kelly M CPA Ireland 'The Role of the Board of Directors in Corporate Governance' available at *https://www.cpaireland.ie/CPAIreland/media/Education-Training/Study%20Support%20Resources/P1%20Corp%20Laws%20and%20Governance/Relevant%20Articles/p1-corp-governance-the-role-of-the-board-of-directors.pdf* (accessed on 4 January 2021).

[43] Price N 'The Role of the Board of Directors in Corporate Governance' available at *https://insights.diligent.com/corporate-governance/the-role-of-the-board-of-directors-in-corporate-governance* (accessed on 20 May 2020).

[44] Price N 'Importance of Corporate Governance in an Organization' available at *https://insights.diligent.com/corporate-governance/importance-of-corporate-governance-in-an-organization* (accessed on 20 November 2020).

[45] toppr 'Appointment of Directors' available at *https://www.toppr.com/guides/business-laws-cs/elements-of-company-law-ii/appointment-of-directors/* (accessed on 20 May 2021).

[46] Abdullah H, Valentine B. 'Fundamental and Ethics Theories of Corporate Governance' 4ed *Middle Eastern Finance and Economics* pg. 89.

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governance nowadays improves 'shareholders communication',[47] and is used in order to ensure that the rights of individual investors are protected – this includes other market participants.[48]

2.2.2.3. Stakeholders

It is important to understand that a shareholder is always a stakeholder, but a stakeholder is not always a shareholder.[49] Every organisation has various stakeholders, such as directors, employees, shareholders, customers, and suppliers. These stakeholders are important for the productivity and efficiency of the organizations.[50] Stakeholders are defined as any group or individual that has the power to affect, or is impacted by, the organization's goals,[51] thus meaning that there is a network of relationships that the stakeholder needs to serve. Stakeholders have an observation role in corporate governance. They express their concerns about any illegal and unethical behavior/practices that they are timeously presented with by the board of directors, whom they elect, so that change can take place and the company present good corporate governance.[52]

2.2.3. Important governing Principles

The Organisation for Economic Co-operation and Development (hereinafter referred to as 'OECD') is an established forum that helps governments of different countries come together and find solutions to common problems. It deals with areas such as economic, social and environmental issues whilst measuring productivity and global flows of trade and investment in order to predict future trends.[53] First published in 1999 and then revised in 2015, the OECD established principles

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[47] MBA Lectures 'Importance of Corporate Governance' available at *https://mba-lectures.com/others/1425/importance-of-corporate-governance.html* (accessed on 1 January 2021).
[48] MBA Lectures 'Importance of Corporate Governance' available at *https://mba-lectures.com/others/1425/importance-of-corporate-governance.html* (accessed on 1 January 2021).
[49] Baton C 'Shareholder vs. Stakeholder': What's the Difference? available at *https://www.investopedia.com/ask/answers/08/difference-between-a-shareholder-and-a-stakeholder.asp#:~:text=Stakeholder%3A%20An%20Overview&text=Shareholders%20are%20always%20stakeholders%20in,than%20stock%20performance%20or%20appreciation* (accessed on 1 January 2021).
[50] MBA Lectures 'Importance of Corporate Governance' available at *https://mba-lectures.com/others/1425/importance-of-corporate-governance.html (*accessed on 1 January 2021).
[51] Abdullah H, Valentine B. (2009) 'Fundamental and Ethics Theories of Corporate Governance' 4ed *Middle Eastern Finance and Economics* pg. 91.
[52] Metalac Ad: 'The role of directors in corporate governance' available at *https://www.metalac.com/en/the-role-of-stakeholders-in-corporate-governance.html* (accessed on 1 June 2021).
[53] OCED 'Better Polices for Better Lives' available at *https://www.oecd.org/about/* (accessed on 15 January 2021).

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to help developing countries governments in regard to their corporate governance frameworks by improving their legal, regulatory and institutional principles.[54]

These are the six main principles of the OECD:

- Protecting and facilitating the exercise of shareholder rights.
- 'Ensuring the basis for an effective corporate governance framework.
- Ensuring the equitable treatment of all shareholders.
- Recognizing the rights of shareholders as established by law.
- Ensuring timely and accurate disclosure on all material information for the corporation; and
- Enhancing the mechanism for the board's accountability to the company and the shareholders while ensuring the effective monitoring of the management by the board'.[55]

Though these principles are not compulsory, they are there to assist countries with adequate guidelines to help implement their own understating of corporate governance.[56]

More corporate governance principles can be seen in the King Code IV Report on Corporate Governance 2016. The following principles for excellent corporate governance are given in this Report: the governing body should guarantee that assurance results in a sufficient and effective control environment, as well as the integrity of reports for improved decision-making.[57]

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More principles from different countries include the Monetary Authority of Singapore Guidelines and Regulations on Corporate Governance.[58] These principles address the attributes of a good governance system. This includes things such as that the corporation should be headed by an effective board of directors that enforces clear responsibility and accountability throughout the corporation. Most principles for good corporate governance are in relation to the board of directors are they as the most important role-players in its success.[59]

[54] UKDiss.com'History and Principles of Corporate Governance' available at *https://ukdiss.com/litreview/history-and-principles-of-corporate-governance.php* (accessed on 4 January 2021).
[55] UKDiss.com 'History and Principles of Corporate Governance' available at *https://ukdiss.com/litreview/history-and-principles-of-corporate-governance.php* (accessed on 4 January 2021).
[56] UKDiss.com 'History and Principles of Corporate Governance' available at *https://ukdiss.com/litreview/history-and-principles-of-corporate-governance.php* (accessed on 4 January 2021).
[57] Institute of Directors Southern Africa (2016) The King IV Report on Corporate Governance pg. 29.
[58] Monetary Authority of Singapore (2013) Code of Corporate Governance.
[59] Monetary Authority of Singapore (2018) Code of Corporate Governance.

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In the United States, corporate governance primarily deals with the control related rights and responsibilities in the following three groups:

- Shareholders not only provide the capital for the firm but also approve all the firm's major decisions;
- The shareholders elected the board of directors for the company and the board oversee the management; and
- The day-to-day operations fall within the management and responsibilities of the senior executives of the firm.[60]

2.2.4. South African Legislation and its Importance to Corporate Governance

In South Africa, corporate governance was first institutionalized in King Code I, which was published in 1994.[61] In South Africa, listed companies operate with the assistance of various robust and flexible governing frameworks, which include South African codes of best practice, statutes, common law and international standards.[62] King Code I helped establish a basis for corporate governance in South Africa and has impacted many frameworks in its development.

2.2.4.1. Companies Act 71 of 2008

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The promotion of good corporate governance and transparency can be found throughout the Companies Act.[63] Section 24(5)[64] of the Act[65] requires that the company keeps all personal details of past and present directors.[66] These provisions are essential in that they recognize that bad corporate governance can be attributed to previous directors who are no longer in office to account for the reckless direction of the company. Section 28[67] states that companies must maintain

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60 McRitchie J. 'Corporate Governance Defined: Not So Easily' available at *http://www.corpgov.net/* accessed on (20 November 2020).
61 Naidoo R 'Corporate Governance: An Essential Guide for South African Companies' 3ed (2002) pg. 11.
62 Davids E, Kitcat R, Midgley L 'The Corporate Governance Review - Edition 10: South Africa' available at *https://thelawreviews.co.uk/edition/the-corporate-governance-review-edition-10/1222293/southafrica#:~:text=The%20purposes%20of%20the%20Companies,economic%20life%20of%20the%20nation* (accessed on 18 January 2021).
63 Act 71 of 2008.
64 Section 24 (5) of the Companies Act 71 of 2008.
65 Act 71 of 2008.
66 Section 24 (5) of the Companies Act 71 of 2008.
67 Section 28 of the Companies Act 71 of 2008

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accounting records for the current and previous seven financial years.[68] This section is in conformity to the corporate governance principles of transparency in that it helps the stakeholders with whom the company transacts to make essentially informed financial decisions. Section 76[69] also sets out a standard of conduct with which the directors must comply, namely that they must act in good faith and for proper purpose in the best interest of the company with care, skill and diligence.[70] If they fail in that, section 77[71] provides that such director will be liable in delict for damages or loss arising from a breach thereof.[72]

2.2.4.2. Public Finance and Management Act 1 of 1999

The Public Finance Management Act 1 of 1999 was enacted to ensure that the management of finances in national and provincial government is regulated in order to ensure transparency, accountability and sound financial management of government and public institutions. Chapter 10, section 81-85[73] lists the consequences for financial misconduct, thus ensuring accountability for those who deal with financial management.[74] Though this legislation applies to state-owned companies, it shows that South Africa has enacted legislation to ensure that good corporate governance principles are implemented by all companies, whether private or public. The King Code's Code of Corporate Practices and Conduct applies, among other things, to SOEs and agencies subject to the PFMA.[75]

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2.2.4.3. Johannesburg Stock Exchange (JSE)

Johannesburg Stock Exchange Limited is the oldest existing and largest stock exchange in Africa. In 2017, an amendment to the listing requirements took place, the most important update being section 3, which deals with corporate governance. The most significant issue is that corporations

[68] Section 28 of the Companies Act 71 of 2008.
[69] Section 76(3) of the Companies Act 71 of 2008.
[70] Section 76(3) of the Companies Act 71 of 2008.
[71] Section 77 of the Companies Act 71 of 2008.
[72] Section 77 of the Companies Act 71 of 2008.
[73] Section 81-85 Public Finance Management Act 1 of 1999.
[74] Public Financial Management Act 1 of 1999.
[75] Department of Public Enterprise 'Protocol of Corporate Governance in the Public Sector' available at *http://www.treasury.gov.za/legislation/pfma/public%20entities/Protocol%20on%20Corporate%20Governance%20in%20the%20public%20sector.pdf* (accessed on 1 June 2021).

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must comply with corporate governance by implementing prescribed practices and disclosing compliance in their annual reports.[76]

2.2.4.4. <u>The King Code IV (King IV)</u>

The King Code is voluntary, which means that it only serves as a company guide on good corporate governance.[77] The King Committee helped inspire many recommendations to the post-1994 amendments to the Companies Act, and even though the King Code was not largely enforced at that time, it quickly became a benchmark on how companies should carry themselves according to corporate governance standards.[78] The implementation or recommended implementation of the King Code can be seen in the following cases.

- ***South African Broadcasting Corporation Ltd and Another v Mpofu***[79]

In this case, the South Gauteng High Court found that the suspension of the group Chief Executive Officer of the SABC was not in accordance with the Articles of Association or good corporate governance. This was further confirmed by the fact that three of the board members were not timeously notified about the meeting or the suspension and were therefore not present, thus not being able to objection to the decision. The Court looked at the King Report on Corporate Governance for South Africa 2002 and stated that the board of directors and companies are required to measure up to the principles set out in the Code, and that the applicable should be applied. The Court further relied on the principle in the King Code that relevant information and facts needs to be timeously and efficiently delivered to the board of directors, which has the responsibility of being objectively satisfied that they have received all the information before decisions are made. Members of the board should also be briefed prior to meetings.[80]

- ***Mthimunye-Bakoro v Petroleum Oil and Gas Corporation of South Africa (Soc) Limited and Another***[81]

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[76] Smith N (2017) LexisNexis The JSE Limited Listings Requirements.
[77] Smith N (2017) LexisNexis The JSE Limited Listings Requirements.
[78] Naidoo R 'Corporate Governance: An Essential Guide for South African Companies' 3ed (2002) pg. 2.
[79] *South African Broadcasting Corporation Ltd and Another v Mpofu* (A5021/08) [2009] ZAGPJHC 25; [2009] 4 All SA 169 (GSJ) (11 June 2009).
[80] *South African Broadcasting Corporation Ltd and Another v Mpofu*.
[81] *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).

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In this matter, the Court was faced with Petroleum Oil and Gas Corporation of South Africa financial loss, totalling R15 000 000 000 (15 billion rand). Mthimunye-Bakoro, who was the Chief Financial Officer, stated that she was not directly responsible for the loss and refused to take voluntary leave, even though the company said that her being at work would be prejudicial to the investigation. The Court found that, due to the nature of circumstances and its seriousness, there were serious breaches of corporate governance codes. The Court then used the King Code IV as a tool to identify a breach of director's duties and referred to the fiduciary duties of directors, for example to act honestly and in the best interests of the company. The duties of care, skill and diligence, which are expected of a reasonable director, were explained briefly.[82]

Companies that are listed on the JSE are required to comply with King IV Code and that has rendered the King Code an enforceable set of rules.[83] The effectiveness of the principles in the King IV Report are supported by the directives contained in the Companies Act.[84] It is without doubt that King IV is a well-drafted document seeking to improve the standards of corporate governance in organisations. Its universal application is a milestone, as all organizations may use King's principles to effect good and proper corporate governance.[85]

The principles above show South Africa's many attempts to ensure that good corporate governance is not only displayed by private companies but public companies. They also show the development of these principles over the years and how they intertwine with each other. These principles can clearly be used to show that there is a need for companies to conduct 'good' practices including not committing acts financial misconduct. In interpreting these principles, I demonstrate the need for directors and audit committee members to have financial literacy in order to combat financial misconduct.

2.3. <u>Business Ethics</u>

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[82] *Mthimunye-Bakoro v Petroleum Oil and Gas Corporation of South Africa (SOC) Limited and Another*.
[83] Smith N (2017) LexisNexis The JSE Limited Listings Requirements.
[84] Grant Thornton 'King III v King IV: What do you really need to know' available at *https://www.grantthornton.co.za/globalassets/1.-member-firms/south-africa/pdfs/kingiv_feb17.pdf* (accessed 28 November 2020).
[85] Grant Thornton 'King III v King IV: What do you really need to know' available at *https://www.grantthornton.co.za/globalassets/1.-member-firms/south-africa/pdfs/kingiv_feb17.pdf* (accessed 28 November 2020).

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Ethics usually entail a code of conduct that tells professionals how they should behave.[86] Acting ethically basically means being able determine what is 'right' and what is 'wrong'.[87] Companies operate in changing environments,[88] so there is a constant need to make choices about actions and decisions that trigger good ethical consequences for individuals and the environment.[89] To create and enhance external commercial ties, ethical principles are formed and managed within the organization.[90]

2.3.1. **History**

The concept of ethics can be traced back to the theories of Greek philosophers such as Socrates, Plato and Aristotle.[91] Their theories became the main topics during the medieval age in Europe.[92] The development of industrial economies between the eighteenth to the early twentieth centuries, saw philosophers such as Adam Smith, John Stuart Mill and Karl Marx speak about the fundamentals regarding ethics, mainly focusing on the rights of workers and arguing the pros and cons of capitalist and socialist models of ownership.[93]

The current use of the term 'business ethics' became very popular in the United States and was divided into two strands.[94] The first strand, 'ethics-in-business', is the lengthy history of applying ethical rules to business in the same way that they have been applied to other aspects of social and

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[86] Fountain L, CPA, CGMA, Fountain GRC LLC 'The Definition of Business Ethics' available at *https://www.tru.ca/__shared/assets/The_Definition_of_Business_Ethics33706.pdf* (accessed on 28 January 2021).
[87] CFI 'Business Ethics' available at *https://corporatefinanceinstitute.com/resources/knowledge/other/business-ethics/* (accessed on 28 September 2021).
[88] Victoria A 'Business Ethics' available at *https://www.researchgate.net/publication/328789262_Business_Ethics* (accessed on 30 January 2021).
[89] Victoria A 'Business Ethics' available at *https://www.researchgate.net/publication/328789262_Business_Ethics* (accessed on 30 January 2021).
[90] Roberts-Lombard M, Mpinganjira M, Wood G, Svensson G 'A construct of code effectiveness: empirical findings and measurement properties' (2016) 10 *African Journal of Business Ethics* pg. 22.
[91] 'A Brief Summary of History of Ethics' (Summarized from Short History of Ethics by Rogers, R.A.P., Mac Millan Books First 1911, ed. 1937 Edinburgh) available at *https://www.realtechsupport.org/UB/WBR/texts/markups/brief_summary_ethics.pdf* (accessed on 6 February 2021).
[92] 'A Brief Summary of History of Ethics' (Summarized from Short History of Ethics by Rogers, R.A.P., Mac Millan Books First 1911, ed. 1937 Edinburgh) available at *https://www.realtechsupport.org/UB/WBR/texts/markups/brief_summary_ethics.pdf* (accessed on 6 February 2021).
[93] Norman W 'Business Ethics' available at *https://onlinelibrary.wiley.com/doi/abs/10.1002/9781444367072.wbiee719* (accessed on 13 January 2021).
[94] De George R 'A History OF Business Ethics' available at *https://www.bbvaopenmind.com/en/articles/a-history-of-business-ethics/* (accessed on 1 February 2021).

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personal life.[95] This strand also focuses on the application of ethics in business on a secular and religious level.[96] The academic field saw the development of the second strand, also known business ethics. This strand is broken up into two branches. The philosophical business-ethics branch and the social-scientific branch: whereas the first branch is normative and critical, the other branch is primarily descriptive and empirical.[97]

2.3.2. **Definition**

Business ethics is a broad field and there are various definitions of it. It may be investigated from a range of perspectives, including philosophical, scientific, and legal ones.[98] Public outcry over various business scandals has motivated companies to behave morally and ethically and hold themselves socially responsible.[99] This scrutiny has led to companies developing their own business ethics policies.[100] It is therefore important to understand these terms.

The following show the various understandings of business ethics.

- It can be seen when controversial issues such as corporate governance, insider trading, bribery, discrimination or corporate social responsibility are being examined.[101]

- Business ethics, applicable in both a professional and personal setting, relate to the moral principles that act as guidelines for action in the business environment and the transactions that are conducted by companies.[102]

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95 De George R 'A History OF Business Ethics' available at *https://www.bbvaopenmind.com/en/articles/a-history-of-business-ethics/* (accessed on 1 February 2021).
96 De George R 'A History OF Business Ethics' available at *https://www.bbvaopenmind.com/en/articles/a-history-of-business-ethics/* (accessed on 1 February 2021).
97 De George R 'A History OF Business Ethics' available at *https://www.bbvaopenmind.com/en/articles/a-history-of-business-ethics/* (accessed on 1 February 2021).
98 White J 'What Is Business Ethics? Definition, Overview, and Example' available at *https://www.thestreet.com/personal-finance/what-is-business-ethics-15026364* (accessed on 9 February 2021).
99 White J 'What Is Business Ethics? Definition, Overview, and Example' available at *https://www.thestreet.com/personal-finance/what-is-business-ethics-15026364* (accessed on 9 February 2021).
100 Fountain L, CPA, CGMA, Fountain GRC LLC 'The Definition of Business Ethics' available at *https://www.tru.ca/__shared/assets/The_Definition_of_Business_Ethics33706.pdf* (accessed on 28 January 2021).
101 Tutorials point 'Business ethics' available at *https://www.tutorialspoint.com/business_ethics/business_ethics_tutorial.pdf* (accessed on 28 January 2021).
102 CFI 'Business Ethics' available at *https://corporatefinanceinstitute.com/resources/knowledge/other/business-ethics/* (accessed on 28 September 2021).

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Business ethics is the study of how a firm should conduct itself in the face of ethical quandaries and contentious circumstances. This might encompass a variety of conditions, such as how a corporation is controlled, how stocks are exchanged, a company's engagement in social concerns, and more.[103]

2.3.3. Governing Principles

It is important, now that business ethics have been explained, to further examine the principles behind it. There are important principles/characteristics that needs to be followed to ensure that business ethics is implemented correctly and that companies not only comply with their own polices and principles but also those expected by society.

These principles are fundamental notions underlying business ethics:

- **Honesty:** A person who is in a director, manager or executive position should ensure that they never purposefully mislead or deceive others by overstatement, partial truths or misrepresentations and that they are honest and truthful.[104]
- **Integrity:** Doing the right thing as an executive is vital, regardless of the pressure to do otherwise; this principle should never be sacrificed for anything or anyone.[105]
- **Compassion and empathy:** Ethical executives need to be compassionate, empathetic, benevolent, kind and caring and strive to achieve the business aims and objectives in a way that generates the least amount of damage and the greatest amount of good.[106]
- **Respect:** Executives should be courteous and treat everyone with decency and respect, regardless of nationality, national origin, ethnicity, or gender.[107]

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[103] White J 'What Is Business Ethics? Definition, Overview, and Example' available at *https://www.thestreet.com/personal-finance/what-is-business-ethics-15026364* (accessed on 9 February 2021).
[104] MBN 'What are ethics? Definition and meaning' available at *https://marketbusinessnews.com/financial-glossary/ethics-definition-meaning/* (accessed on 10 February 2021).
[105] MBN 'What are ethics? Definition and meaning' available at *https://marketbusinessnews.com/financial-glossary/ethics-definition-meaning/* (accessed on 10 February 2021).
[106] MBN 'What are ethics? Definition and meaning' available at *https://marketbusinessnews.com/financial-glossary/ethics-definition-meaning/* (accessed on 10 February 2021).
[107] MBN 'What are ethics? Definition and meaning' available at *https://marketbusinessnews.com/financial-glossary/ethics-definition-meaning/* (accessed on 10 February 2021).

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- **Law-abiding:** ’Respect and abide by the laws, regulations and rules’.[108]

- **Leadership:** Executives are positive ethical role models and must build an atmosphere that values ethical decision-making and principled thinking.[109]

- **Reputation and morale**: Executives must establish and preserve the company’s excellent reputation, as well as the morale of its employees, and ‘avoid becoming involved in behaviour that may erode respect and will take all necessary steps to prevent others from acting inappropriately’.[110]

- **Accountability:** Executives who are ethical should take responsibility for the ethical nature of their decisions.[111]

These principles showcase what is expected of a company/board of directors when it comes to business ethics. It then makes it easy to establish the link between business ethics and corporate governance and the role they both play in combating financial literacy.

2.3.4. <u>South African Implementation and Importance to Business Ethics</u>

As ethics is the study of moral values and conduct, there is a visible link between this and corruption. As corruption is human conduct that goes against what the moral expectation of what is ‘right’ or accepted in a society, it is unethical conduct.[112] Even though there are different measures, such as anti-fraud initiatives, that are put in place to ensure that businesses function less corruptly in South Africa, corruption is still a major problem.[113] The emergence of one scandal after another raises the question of whether business owner/employees have truly understood the serious problem with corruption and the need for change. South Africa has gone through its own

[108] MBN ‘What are ethics? Definition and meaning’ available at *https://marketbusinessnews.com/financial-glossary/ethics-definition-meaning/* (accessed on 10 February 2021).
[109] MBN ‘What are ethics? Definition and meaning’ available at *https://marketbusinessnews.com/financial-glossary/ethics-definition-meaning/* (accessed on 10 February 2021).
[110] MBN ‘What are ethics? Definition and meaning’ available at *https://marketbusinessnews.com/financial-glossary/ethics-definition-meaning/* (accessed on 10 February 2021).
[111] MBN ‘What are ethics? Definition and meaning’ available at *https://marketbusinessnews.com/financial-glossary/ethics-definition-meaning/* (accessed on 10 February 2021)..
[112] Bassey EP, Ochulor CL ‘Analysis of Corruption from the Ethical and Moral Perspectives’ (2010) 44 *European Journal of Scientific Research* pg. 469.
[113] The Skill Portal ‘South Africa in need of higher business ethic standing’ available at *https://www.skillsportal.co.za/content/south-africa-need-higher-business-ethic-standing* (accessed of 22 February 2021).

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ethical changes throughout the years. Since the abolishment of apartheid, there has been significant change in South Africa's business operations over the past two decades.[114]

The King Code II made recommendations to ensure that business ethics are taken into consideration by companies, such as by ensuring that there are polices and principles that regulate the behaviour of CEOs, managers and employees.[115] This shows the importance that South Africa started to place on business ethics to ensure that companies behave more ethically.

Another example is the South African Charter of Ethical Business Practice, though it is only seen as a reference document which deals with ethical business standards. It looked at various documents including Caux Round Table Principles for Responsible Business, UN Global Compact, and the Harvard Global Business Standards Codex for inspiration.[116]

As financial misconduct is seen as unethical behavior, it is important to examine the concept and the importance it has in South Africa. Doing this establishes that it is not regarded as acceptable behavior by society or legislation and needs to be dealt with more effectively.

2.4. <u>Financial Misconduct</u>

Financial misconduct deals with anything that negatively contributes, whether it be directly or indirectly, to a company's finances or financial operation, including fraud, gross negligence misappropriation, mismanagement, waste or theft of finances, and intentional or willful misconduct.[117]

South Africa is not immune to global developments. This includes major changes that took place regarding South Africa's financial management and the financial accountability of those in

[114] Roberts-Lombard M, Mpinganjira M, Wood G, Svensson G 'A construct of code effectiveness: empirical findings and measurement properties' (2016) 10 *African Journal of Business Ethics* pg. 19.
[115] Erasmus BJ, Wordsworth R 'Aspects of business ethics in South Africa' (2004) 28 *South African Journal of Labour Relations* pg. 82.
[116] Business Unity South Africa 'South African Charter of Ethical Business Practice' available at *https://www.nacf.org.za/busa_workshop/BUSA_Charter_of_Ethical_Business_Practice.pdf* (accessed on 22 February 2021).
[117] Law Insider 'Financial Misconduct definition' available at *https://www.lawinsider.com/dictionary/financial-misconduct* (accessed on 3 August 2021).

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charge.[118] While business in the public sector has become corrupt, this can be equally seen within the private sector, as South Africa has become a major 'hotbed in economic crimes'.[119] In South African governmental and business sectors, the past decade has undoubtedly seen a number of scandals, 'each displaying a blatant lack of ethics and each fraudulent in their own unique way'.[120] Within the private sector, the growing concern over financial misconduct has become very apparent, as have the attempts to prevent such acts.[121]

The following are examples of the growing financial misconduct in South Africa.

- **VBS Bank**

In 2018, advocate Terry Motau released his report into fraud and corruption at VBS bank, where it was estimated that nearly R2 billion was looted by false financial deposits and by convincing municipalities to invest in the bank. It is estimated that at least 50 people benefitted from it.[122]

- **Tongaat Hulett**

South Africa's biggest sugar producer was said to have overstated its financial results in 2018 by between R3.5 billion to R4.5 billion; it remains suspended on the Johannesburg Stock Exchange (JSE) and in London .[123] It is said to be the fault of ten former executives, 'including ex-CEO Peter Staude, who was paid more than R170m in a decade'.[124]

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[118] Sambo VT 'Internal Audit and Financial Misconduct: The Case of the South African Social Security Agency (SASSA)' available at *http://ulspace.ul.ac.za/bitstream/handle/10386/2505/sambo_internal_2018.pdf?sequence=1&isAllowed=y* (accessed on 20 January 2021).
[119]Carbone G *South Africa: The need for change* 1st ed (2016) Ch 4.
[120] Business Insider SA 'The biggest South African business scandals over the past decade' available at *https://www.businessinsider.co.za/the-top-south-african-business-scandals-the-past-decade-2020-1* (accessed on 15 November 2021).
[121] Carbone G *South Africa: The need for change* 1st ed (2016) Ch 4.
[122] Business Insider SA 'The biggest South African business scandals over the past decade' available at *https://www.businessinsider.co.za/the-top-south-african-business-scandals-the-past-decade-2020-1* (accessed on 15 November 2021).
[123] Business Insider SA 'The biggest South African business scandals over the past decade' available at *https://www.businessinsider.co.za/the-top-south-african-business-scandals-the-past-decade-2020-1* (accessed on 15 November 2021).
[124] Business Insider SA 'The biggest South African business scandals over the past decade' available at *https://www.businessinsider.co.za/the-top-south-african-business-scandals-the-past-decade-2020-1* (accessed on 15 November 2021).

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- **Bosasa**

African Global Operations, established in 1995, was 'accused of widespread corruption and undue influence with the state, and is estimated to have received government tenders to the value of R12 billion between 2003 and 2018'.[125]

With financial misconduct having drawn increased public attention, this encourages better financial management, administration and accountability.[126]

The Public Service Commission (OSC) was established under Section 196 of the Constitution.[127] The PSC is an independent and unbiased body tasked with investigating and evaluating the Public Service's organization, administration, and personnel practices.[128] This includes the monitoring and evaluation of financial misconduct.[129] This is read in conjunction with the Public Financial Management Act 1 of 1999 (PFMA). These can be adapted by managers and directors so that there is accountability and broad frameworks of best practices.[130]

The aim of the PFMA is promote fiscal discipline and transparency in the management of public finances, which has been a positive step in South Africa.[131] Chapter 10 of the PFMA defines financial misconduct. Sections 81- 83[132] deal with the financial misconduct of 'public officials' and how they should be dealt with when misconduct occurs.

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[125] Business Insider SA 'The biggest South African business scandals over the past decade' available at *https://www.businessinsider.co.za/the-top-south-african-business-scandals-the-past-decade-2020-1* (accessed on 15 November 2021).
[126] Public Service Commission 'Overview on Financial Misconduct for 2006/2007 financial year' available at *https://www.gov.za/sites/default/files/gcis_document/201409/pscrpt-financial-misconduct.pdf* (accessed on 6 February 2021).
[127] Section 196 of The Constitution of the Republic of South Africa Act 108 of 1996.
[128] Public Service Commission 'Overview on Financial Misconduct for 2006/2007 financial year' available at *https://www.gov.za/sites/default/files/gcis_document/201409/pscrpt-financial-misconduct.pdf* (accessed on 6 February 2021).
[129] Public Service Commission 'Overview on Financial Misconduct for 2006/2007 financial year' available at *https://www.gov.za/sites/default/files/gcis_document/201409/pscrpt-financial-misconduct.pdf* (accessed on 6 February 2021).
[130] National Treasury Republic of South Africa 'Guide for Accounting Officers Public Finance Management Act' available at *http://www.treasury.gov.za/legislation/pfma/guidelines/Accounting%20Officers%20Guide%20to%20the%20PFMA.pdf* (accessed on 6 February 2021).
[131] Sambo VT 'Internal Audit and Financial Misconduct: The Case of the South African Social Security Agency (SASSA)' available at *http://ulspace.ul.ac.za/bitstream/handle/10386/2505/sambo_internal_2018.pdf?sequence=1&isAllowed=y* (accessed on 20 January 2021).
[132] s81- s83 of the Public Financial Management Act 1 of 1999.

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Though measures have been taken to ensure that financial misconduct is effectively dealt with, this does not seem to have made a difference in reality. It seems to be increasing, in fact, so identifying the cause of these cases will help bring about change. In the few cases, there seems to be a lack of direction from directors, including lack of understanding of their role and lack of ability to carry out their duties, for instance having little or no financial literacy yet having to deal with financial statements.

2.5. <u>Financial Literacy</u>

It is important to get a brief understanding of financial literacy, though it will be investigated in more depth in both chapter 3 and chapter 4. This is important so that a review of the relationship between corporate governance, business ethics and financial literacy can be made to show how it can be used as a tool to combat financial misconduct.

Financial literacy is an important concept in the business world; it is seen as the ability to comprehend financial language, statements and ideas and use this knowledge to financial effect.[133] This concept cannot be overlooked, as shareholders and boards of directors have the responsibility to their employees, customers and suppliers to ensure that they run the company correctly; this includes having proper financial literacy for dealing with the company's financial records.[134] The decision-makers' degree of knowledge, especially their financial literacy, will have a significant impact on the quality of these decisions.[135] In terms of economic growth. it is believed that this could be a key factor, as management decisions have a direct impact on a business's financial performance and, ultimately, the economy.[136]

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[133] Cote C 'The Importance of Financial Literacy in Business' available at *https://online.hbs.edu/blog/post/importance-of-financial-literacy* (accessed on 9 February 2021).

[134] Astute mode 'Entrepreneurs & business owners: Are you financially literate enough to succeed?' available at *https://www.astutemode.com/importance-financial-literacy-entrepreneurs/* (accessed on 16 February 2021).

[135] Kozarevic E, Kokorovic MJ, Džafić J 'Importance of Financial Literacy for Organizational Decision-making Towards Economic Growth: Evidence from Tuzla Canton, Bosnia And Herzegovina' 5 International Scientific Symposium Economy of Eastern Croatia - Vision and *Growth* (2016) *Sveučilište Josipa Jurja Strossmayera u Osijeku, Ekonomski fakultet u Osijeku* pg. 449.

[136] Kozarevic E, Kokorovic MJ, Džafić J 'Importance of Financial Literacy for Organizational Decision-making Towards Economic Growth: Evidence from Tuzla Canton, Bosnia And Herzegovina' 5 International Scientific Symposium Economy of Eastern Croatia - Vision and *Growth* (2016) *Sveučilište Josipa Jurja Strossmayera u Osijeku, Ekonomski fakultet u Osijeku* pg. 449.

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The OECD's 'Recommendation on Principles and Good Practices for Financial Education and Awareness' makes recommendations regarding financial literacy to ensure that companies improve their financial understanding.

These recommendations include:

- The importance of financial education should be a priority and made clear, as it fosters good corporate governance,

- Codes of conduct in financial institutions should be improved and developed to ensure that financial education and commercial advice are clearly separated and distinguished; and

- Clients' understanding of information when making long-term commitments or when using financial services with potentially significant financial consequences should be encouraged and observed by financial institutions.[137]

Now that financial literacy has been briefly explained, I will be able to find the link between it, business ethics and corporate governance and how these can be used as tools to combated financial misconduct within companies. Furthermore, in the next few chapters, I will apply the understanding of financial literacy to directors and audit committee members.

2.6. Relationship between Corporate Governance, Business Ethics and Financial Literacy to Combat Financial Misconduct

Corporate governance and business ethics are two terms that are commonly used in relation to each other. They are both important terms when one looks at the growth of companies. With the decline in proper corporate governance and business ethics evident in the various financial crisis faced today,[138] it is all the more urgent to establish better governance and ethical frameworks. It is

[137] Organisation for Economic Co-Operation and Development Policy Brief 'The Importance of Financial Education' available at *http://www.oecd.org/finance/financial-education/37087833.pdf* (accessed on 16 February 2021).
[138] Clarke T 'OpenMind BBVA: Ethics, Values and Corporate Governance' available at *https://www.bbvaopenmind.com/en/articles/ethics-values-and-corporate-governance/* (accessed on 19 May 2020).

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thus vital to establish how these terms intertwine with each other. Business ethics gives individuals the tools they need to deal with moral ambiguity in the workplace.[139] Corporate governance, on the other hand, is concerned with corporate ownership, control, and responsibility.[140] It is important to remember that most, if not all, business decisions have an ethical component and that business governance has ethical and social consequences.

Business ethics and corporate governance have an interrelationship. The values of fairness, accountability, responsibility and transparency (which are also cornerstones of business ethics)[141] are key to corporate governance. This creates the idea that for good governance to exist, ethics needs to be applied so that companies can meet these obligations.[142] When all the role-players within a company's role/duties are defined, it becomes easier for the principle of corporate governance to be applied and a distinctive ethical character to emerge.[143] The relationship between ethics and governance is created by those who implement the corporate governance of the company (shareholders and executive managers), as they decide the ethical principles that employees will follow.[144]

Financial literacy is vital to ensure that proper financial records and bookkeeping of a company is done. Without this, the door is opened to financial misconduct. The relationship between corporate ethics and financial performance is being recognized by an increasing number of firms.[145] By using financial literacy to combat financial misconduct, companies can promote better ethical behavior and corporate governance principles. Since those in charge (boards of directors) are the ones that implement corporate governance and ethics to the employees below, it is important for them to act ethically too.

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[139] Ramakrishnan (2007) 'Inter-Relationship between Business Ethics and Corporate Governance Among Indian Companies' International Seminar at The Institute of Management, NIRMA University, Ahmadabad pg. 2.
[140] Ramakrishnan (2007) 'Inter-Relationship between Business Ethics and Corporate Governance Among Indian Companies' International Seminar at The Institute of Management, NIRMA University, Ahmadabad pg. 2.
[141] Fernando A.C 'Business Ethics and Corporate Governance' First Edition (2009) pg. 88.
[142] Rossouw G.J 'Business ethics and corporate governance in the Second King Report: Farsighted or futile?' Rand Afrikaans University, 2002 pg. 407.
[143] Rossouw G.J 'Business ethics and corporate governance in the Second King Report: Farsighted or futile?' Rand Afrikaans University, 2002 pg. 407.
[144] Vitez O 'What is the Relationship Between Business Ethics and Corporate Governance?' available at *https://www.infobloom.com/what-is-the-relationship-between-business-ethics-and-corporate-governance.htm* (accessed on 1 June 2021).
[145] Tyagi A 'Role of Business Ethics and Corporate Governance in Business Success' (2014) 4 *International Journal of Engineering and Management Research* pg. 213.

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2.7. <u>Chapter Conclusion</u>

The chapter has highlighted my understanding of corporate governance, its importance in South Africa and what rules and legislation govern it. The same goes for business ethics. I further explored the concepts of financial misconduct and financial literacy and why they are important in reducing financial misconduct. I have thus laid the foundation for my thesis.

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3. Chapter 3: Board of Directors

3.1. Introduction

In order to ensure that financial misconduct is curbed, I will be exploring one of the most important role-players in a company, the board of directors. I will be examining the different types of directors and their roles, as well as the legislation and governing principles that help govern directors. Once I have established this, I will focus on the role directors play in corporate governance, business ethics and financial misconduct.

3.2. Board of Directors

In corporate governance, the separation of ownership and control is a central theme. This entails that the 'shareholders own the company, but the managers control the operations'.[146] This is where the board of directors comes in. It is made up of a panel of people who are essential for the running of a company and who represent the shareholders. The Companies Act[147] defines a director as any individual assuming the post of director or alternate director.[148] It is a legal requirement that all companies appoint a board of directors.[149] The board is there to establish corporate values and effective governance structures for the company, both on an individual and group level. It represents the shareholders' interests within the company by way of a fiduciary relationship – this means that the board of directors ensures that the company runs smoothly, effectively and has all the tools needed to do so.[150] For a company to run smoothly, the interests of shareholders and stakeholders must be aligned and taken into consideration.[151] When the 'board acts independently

[146] The Strategic CFO 'What is a Board of Directors?' available at *https://strategiccfo.com/board-of-directors/* (accessed on 30 June 2021).
[147] Act 71 of 2008.
[148] Section 66(6) of the Companies Act 71 of 2008.
[149] CIF 'Board of Directors: A panel of individuals that are elected to represent shareholders' available at *https://corporatefinanceinstitute.com/resources/careers/jobs/board-of-directors/* (accessed 30 June 2021).
[150] CIF 'What is a Board of Directors' available at *https://corporatefinanceinstitute.com/resources/careers/jobs/board-of-directors/* (accessed 11 November 2021).
[151] The Strategic CFO 'What is a Board of Directors?' available at *https://strategiccfo.com/board-of-directors/* (accessed on 30 June 2021).

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and as a custodian of shareholder and stakeholder interests',[152] a meaningful relationship coexists between them that results in good corporate governance.[153]

3.2.1. Types of Directors

To establish the role that financial literacy plays in regard to directors' financial misconduct, I first need to establish the types of directors and their roles within the company.

3.2.1.1. Executive Directors

These types of directors are involved in the day-to-day management of the company. They are employed full-time with a monthly salary by the company (which includes subsidiaries).[154] They also have a deep grasp of and expertise in the company's internal workings, which comes with the additional duty of ensuring that information presented to the board by management is an accurate portrayal of their insight into the company's affairs.[155] Under section 68(1),[156] directors are elected to serve for an indefinite time or for the duration specified in the company's Memorandum of Incorporation. (MOI).[157]

3.2.1.2. Non-executive Directors

Non-executive directors are not involved in the day-to-day running of the company and therefore provide much-needed objectivity and independence in the management of the company.[158] They

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[152] MSG 'The Relationship between the Board of Directors and the Management' available at *https://www.managementstudyguide.com/board-of-directors-and-management.htm* (accessed 11 November 2021).
[153] MSG 'The Relationship between the Board of Directors and the Management' available at *https://www.managementstudyguide.com/board-of-directors-and-management.htm* (accessed 11 November 2021).
[154] Institute of Directors Southern Africa 'General Guidance Note Frequently Used Terms For Directors And The Governance Role-players' available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/General_guidance_note_on_frequently_used_terms_for_directors_and_Governance_role_players_.pdf* (accessed on 10 July 2021).
[155] RMS 'Executive, Non-Executive and Independent Directors' available at *https://www.rsm.global/southafrica/news/executive-non-executive-and-independent-directors* (accessed on 10 July 2021).
[156] Section 68 (1) of the Companies Act 71 of 2008.
[157] Institute of Directors Southern Africa 'General Guidance Note Board Composition' available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/General_Guidance_Note_on_Board_Composition.pdf* (accessed on 30 July 2021).
[158] Deloitte. 'Duties of Directors' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_DutiesOfDirectors2013_16042014.pdf* (accessed on 21 July 2021).

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are not employed by the company full-time. The areas where non-directors' independence is the most valuable are 'strategy, performance, sustainability, resources, transformation, diversity, employment equity, standards of conduct and evaluation of performance'.[159] The King Code IV provides that independent non-executive directors are allowed for serve for a period longer than nine years.[160]

3.2.1.3. Independent Non-Executive Directors

There is no relationship between the director and company, directly or indirectly. In order to ensure that they remain fully independent, they should be free of any relationship that could materially interfere with their judgment. They do not represent the thoughts or ideas of the shareholders.[161]

I will now further explore the directors that are specifically recognised by South African legislation to give further understanding of directors.

3.2.2. Recognized Directors in South African

As mentioned above, the directors discussed are not distinguished by the Companies Act,[162] but this does not mean that the Act does not mention other types of directors. The types of directors mentioned above are the basic umbrella terms for various directors, whereas the Companies Act[163] makes specific recognition to the following directors.

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3.2.2.1. Nominee Director

This type of director is appointed by either the shareholders, creditors or interest groups to the company.[164] The nominee director does not only serve the interest of the company but also is

[159] Deloitte. 'Duties of Directors' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_DutiesOfDirectors2013_16042014.pdf* (accessed on 21 July 2021).
[160] Institute of Directors Southern Africa 'Board independence: King IV recommends a balanced approach' available at *https://www.iodsa.co.za/news/486122/Board-independence-King-IV-recommends-a-balanced-approach.htm* (accessed on 10 July 2021).
[161] RMS 'Executive, Non-Executive and Independent Directors' available at *https://www.rsm.global/southafrica/news/executive-non-executive-and-independent-directors* accessed on (10 July 2021).
[162] Act 71 of 2008.
[163] Act 71 of 2008.
[164] Lekgau E.T *Fiduciary Duties of Nominee Director* (Unpublish LLM thesis, University of Pretoria,2016) pg. 5.

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expected to serve the interest of the party that appointed the director; this can also be known as a de jure director.[165] Section 66[166] defines what is a director under South African law, doing so so broadly that it also allows nominee directors to fall under this, allowing them the same duties as the rest of the members on the board.[167]

3.2.2.2. <u>Puppet director</u>

Puppet directors are not seen as independent directors on the board; they are normally directors that are controlled by shadow directors and follow instructions.[168] They do not always act in the best interest of the company but rather act in the best interest of the shadow directors who instruct them.[169] These directors, unlike the shadow directors, will be legally liable for any loss suffered by the company.[170]

3.2.2.3. <u>Ex officio director</u>

This is someone such as a CEO or a CFO who gets their role as a director through the office that they hold. The appointment of this director can be found under section 66(4),[171] which provides that a person who holds another office, title, designation or similar status can via the MOI of the company be appointed as an ex officio director.[172]

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3.2.2.4. <u>Alternate director</u>

[165] Company Partners 'Who and what is a company director?' available at *https://ptycompanyregistration.co.za/companydirectors/* (accessed on 12 July 2021).
[166] Section 66 (7)(a) of the Companies Act 71 of 2008.
[167] Lekgau E.T *Fiduciary Duties of Nominee Director* (Unpublish LLM thesis, University of Pretoria,2016) pg. 5.
[168] Levenstein E 'Multiple directorships a potential liability under New Companies Act: Eric Levenstein, Director' available at *https://www.werksmans.com/legal-updates-and-opinions/multiple-directorships-a-potential-liability-under-new-companies-act-eric-levenstein-director/* (accessed on 11 November 2021).
[169] Levenstein E 'Multiple directorships a potential liability under New Companies Act: Eric Levenstein, Director' available at *https://www.werksmans.com/legal-updates-and-opinions/multiple-directorships-a-potential-liability-under-new-companies-act-eric-levenstein-director/* (accessed on 11 November 2021).
[170] Levenstein E 'Multiple directorships a potential liability under New Companies Act: Eric Levenstein, Director' available at *https://www.werksmans.com/legal-updates-and-opinions/multiple-directorships-a-potential-liability-under-new-companies-act-eric-levenstein-director/* (accessed on 11 November 2021).
[171] Section 66(4) of the Companies Act 71 of 2008.
[172] Section 66(4) of the Companies Act 71 of 2008.

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As defined in section 1 of the Companies Act,[173] an alternate director is an elected or appointed director of a company who is unable to serve on the board; an alternate director is elected or appointed to take their place as a substitute till that director can return.[174]

3.2.2.5. De facto Directors

These directors take up the role of a director and act as the director but are never formally appointed to be a director on the board.[175] The de facto director recognition can found within section 66,[176] which not only includes formally appointed directors, but the appointment of de facto directors as well

3.2.2.6. Shadow Director

Another important director is not mentioned in the Companies Act:[177] the shadow director. As the name suggests, this type of director lurks in the shadows and influences other directors, while trying to remain anonymous and not taking up any formal position on the board of directors.[178] Since these type of 'directors' are actually not identified as directors, it is difficult to say whether they are governed by the Companies Act;[179] they are also able to avoid legal liability in regard to the company for any influence or control they have.[180] Some believe that shadow directors are prescribed officers, yet when looking at what a prescribed officer is, it is someone who, though not a director, has whole or a significant control or management over part of the company's business.[181] In my view, a shadow director does not have any significant control or management over the company's business and therefore should not be viewed as a prescribed officer.

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173 Act 71 of 2008.
174 Section 1 of the Companies Act 71 of 2008.
175 Deloitte. 'Duties of Directors' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_DutiesOfDirectors2013_16042014.pdf* (accessed on 21 July 2021).
176 Section 66 of the Companies Act 71 of 2008.
177 Act 71 of 2008.
178 Cassim R 'South African law is failing to make sure that 'shadow directors' are held accountable' available at *https://www.unisa.ac.za/sites/corporate/default/Colleges/Law/News-&-events/Articles/South-African-law-is-failing-to-make-sure-that-shadow-directors-are-held-accountable* (accessed on 11 November 2021).
179 Act 71 of 2008.
180 Cassim R 'South African law is failing to make sure that 'shadow directors' are held accountable' available at *https://www.unisa.ac.za/sites/corporate/default/Colleges/Law/News-&-events/Articles/South-African-law-is-failing-to-make-sure-that-shadow-directors-are-held-accountable* (accessed on 11 November 2021).
181 Cassim R 'South African law is failing to make sure that 'shadow directors' are held accountable' available at *www.unisa.ac.za/sites/corporate/default/Colleges/Law/News-&-events/Articles/South-African-law-is-failing-to-make-sure-that-shadow-directors-are-held-accountable* (accessed on 6 December 2021).

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Now that I have established the different directors recognised by South African legislation and principles, I can better showcase their roles within the company how and how they can play a part when dealing with financial misconduct through financial literacy.

3.2.3. Composition of the Board of Directors

It is important to establish how board members are appointed and how many board members need to be appointed for a company. This will also help to establish how many of them should be financially literate and need to take financial responsibility, or if this should rest only on a certain number of the board members.

Section 66(2)(a) of the Companies Act,[182] provides that at least one director is needed for a private or personal liability company.[183] Section 66(2)(b)[184] then goes further and gives the directions for public and non-profit companies and states that these companies need a minimum of 3 directors.[185] In addition to the minimum number of directors that is set out by the Act, the MOI of a company can specify a higher number of directors, as the board also needs to comprise of additional directors in order to appoint an audit committee, or a social and ethics committee.[186] As previously mentioned, the board of directors is a vital driving force for the positive social and economic impact of a company.[187] The size of the board all depends on the size of the company, though there is no fixed opinion on whether a board needs to be large or small and therefore the size is determined by the MOI, in relation to the Companies Act.[188] It is important to see that there are both pros and cons to a large and small board of directors.

The advantages of a larger board are that it allows for the workload to be equally split and managed by the members, and for more perspectives and viewpoints to be represented as each board member will bring different skills to the table; where there is a leadership change, there is a better chance

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[182] Section 66(2)(a) of the Companies Act 71 of 2008.
[183] Section 66(2)(a) of the Companies Act 71 of 2008.
[184] Section 66(2)(a) of the Companies Act 71 of 2008.
[185] Section 66(2)(a) of the Companies Act 71 of 2008.
[186] Wiese T '*Corporate Governance in South Africa with International Comparisons'* (2014) pg. 94.
[187] Cossin D *'High Performance Boards: Improving and Energizing your Governance'* (2020) pg. 1.
[188] Garoyan L, Mohn PO *'The Board of Directors of Cooperatives'* (1985) pg. 178.

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of continuity.[189] The disadvantages of a large board of directors are that meaningful activity and participation by every board member is not always allowed, scheduling conflicts occur more easily, and shift of responsibility is very likely to happen, as when board members shift their duties and responsibility to the shareholders and stakeholders or to another board member. It becomes more difficult and expensive to manage a larger board of directors.[190]

When it comes to a smaller board, this also has advantages and disadvantages. The advantages are that the communication and interaction between the members of the board are easier; this results in better unity and common purpose. It is easier to schedule meetings, simpler to make swift decisions, and the board is able to adapt to change quicker; each member has to take responsibility, and it is easier and less expensive to manage a smaller board.[191] When it comes to the cons of a smaller board, the workload can become too much for such few people; there are fewer perspectives and viewpoints represented; with less members, less skills and experience are brought by members, and there can be potential difficulties in decision-making.

3.3. <u>Role of the Board of Directors (Duties and Responsibilities)</u>

Understanding the general duties and responsibilities of the board of directors shows the importance of having the right qualifications to be able to perform the duties and responsibilities that are expected of them.

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One of the main responsibilities of the board of directors is to establish corporate values and governance structures for the company and to ensure that there are established long-term strategic objectives for the company so that it is able to perform adequately in future.[192] The success or failure of a corporation depends largely on the choices of the directors, and therefore it is vital that

[189] Institution of Directors South Africa 'General Guidance Note Board Size' available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/General_guidance_note_on_board_size_final.pdf* (accessed on 21 July 2021).
[190] Institution of Directors South Africa 'General Guidance Note Board Size' available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/General_guidance_note_on_board_size_final.pdf* (accessed on 21 July 2021).
[191] Institution of Directors South Africa 'General Guidance Note Board Size' available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/General_guidance_note_on_board_size_final.pdf* (accessed on 21 July 2021).
[192] Naidoo R *Corporate Governance: An Essential Guide for South African Companies* 3ed (2002) pg. 56.

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they exercise their powers to the benefit of the shareholders, which in turn is to the benefit of the company.[193]

The eight points below also help outline the major duties and responsibilities that the board of directors have within a company.

- **Establishing a Company's Mission and Purpose**

It is important that a company has a mission and a purpose when it is established; this is something that every board of directors needs to take direction from and ensure that the company conduct its business accordingly.[194]

- **Selecting, Supporting and Overseeing Executive Directors**

Executive director are appointed by the board of directors; this is done by selecting and vetting the pool of candidates. Once this process is completed, the board works very closely with the executive director to ensure that the purpose and mission of the company is carried out.[195]

- **Company Planning**

Company planning is an important management responsibility that is entrusted to the board of directors. In order to ensure the growth of the company, the board needs to establish certain objectives such as what the goals of the company are, how they plan to achieve these goals and the time period to achieve them.[196] It is therefore important for the board of directors to strategically plan and monitor the company products, services or programmes; this will also ensure they can set new goals.[197]

- **Monitoring and Managing Financial Resources**

[193] Baysinger B.D, Butler N.H 'Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition' (1985) vol 1 *Journal of Law, Economics, & Organization* pg. 101.
[194] Barlow J 'What are a Board Member's Responsibilities?' available at *https://www.boardeffect.com/blog/board-member-responsibilities/* (accessed on 28 July 2021).
[195] Barlow J 'What are a Board Member's Responsibilities?' available at *https://www.boardeffect.com/blog/board-member-responsibilities/* (accessed on 28 July 2021).
[196] Johnson K 'The importance of business planning' available at *https://www.caaa.biz/the-importance-of-business-planning/* (accessed 12 November 2021).
[197] Barlow J 'What are a Board Member's Responsibilities?' available at *https://www.boardeffect.com/blog/board-member-responsibilities/* (accessed on 28 July 2021).

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The board of directors need to monitor the funds of the company and it is therefore important that board members can read and understand financial statements. They do not need to have expertise in the financial field but should have basic financial literacy.[198]

- **Serve on Committees**

Board members are required to serve on any committees or task forces in the company that needs their assistance, as well as to take on special assignments if the need arises.[199] These committees include but are not limited to the audit committee (assisting the board with financial oversight), the remuneration committee (assisting with the appointment of executive directors and all different aspects surrounding that), the risk committee (assisting with the company's risk policies) and the shareholders grievance committee (assisting with shareholders and investor concerns).[200]

- **Recruiting New Board Members**

Looking out for new board members is one of the responsibilities that the board members take on. Through networking opportunities, they look for people who can bring additional knowledge, talent, experience, or perspective to the board.[201]

- **Maintaining Integrity**

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It is the responsibility of board members to retain confidentiality regarding sensitive matters and other private board member matters.[202]

- **Risk Management**

Another important duty that falls within the scope of the board of directors is risk management. Under the King IV, special mention is made of the importance of risk management – principle 11 states that the board should ensure that it is aware and governs the risk of the company to ensure

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[198] Barlow J 'What are a Board Member's Responsibilities?' available at *https://www.boardeffect.com/blog/board-member-responsibilities/* (accessed on 28 July 2021).
[199] Barlow J 'What are a Board Member's Responsibilities?' available at *https://www.boardeffect.com/blog/board-member-responsibilities/* (accessed on 28 July 2021).
[200] Academike 'Board Committees and it's Importance' available at *https://www.lawctopus.com/academike/board-committees-importantce/* (accessed on 12 November 2021).
[201] Barlow J 'What are a Board Member's Responsibilities?' available at *https://www.boardeffect.com/blog/board-member-responsibilities/* (accessed on 28 July 2021).
[202] Barlow J 'What are a Board Member's Responsibilities?' available at *https://www.boardeffect.com/blog/board-member-responsibilities/* (accessed on 28 July 2021).

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positive outcomes when planning the future of the company.[203] The way in which this can be done is for the board to ensure that a proper risk committee is established, that the board is given all the important information regarding risks the company may face; and that there is proper establishment of a risk management system.[204]

Now that I have established some of the key duties and responsibilities of directors, I can explore the rules and legislations that govern these duties and responsibilities.

3.4. Legislation and Principles governing Directors' Duties and Responsibilities

Establishing the rules and regulations that govern directors is important. This showcases the importance that is placed on directors and the way they need to carry out their duties. Once this has been mentioned, I will be able to show how directors' financial misconduct goes against these rules and regulations and how relying on financial literacy can help lessen the misconduct that the country is faced with in these present times. In the previous chapter, I mentioned the important role that directors play as one of the key role-players in corporate governance.

Companies Act

Under the Companies Act,[205] section 1[206] and section 66[207] define what qualifies as a director; there is no provision that gives specific qualification requirements for appointing a director. The Companies Act[208] under section 69[209] rather provides for what disqualifies a person from serving as director.[210]

Requirements for good corporate governance and transparency can be found throughout the Companies Act, especially in regard to directors. This can be seen in various sections within the Companies Act, and I will explore some of these important sections. Section 24(3)(b) (i-ii) of the

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[203] Institute of Directors Southern Africa (2016) King IV: Report on Corporate Governance for South Africa.
[204] du Plessis P, Natesan P 'Key principles of risk oversight' available *at* *https://www.iodsa.co.za/news/452777/Key-principles-of-risk-oversight.htm* (accessed on 12 November 2021).
[205] Act 71 of 2008.
[206] Section 1 of the Companies Act 71 of 2008.
[207] Section 66(7)(a) of the Companies Act 71 of 2008.
[208] Act 71 of 2008.
[209] Section 69 of the Companies Act 71 of 2008.
[210] Institution of Directors South Africa 'General Guidance Note Board Size' available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/General_guidance_note_on_board_size_final.pdf* (accessed on 21 July 2021).

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Companies Act requires that the company keeps all personal details of past and present directors for seven years.[211] These provisions are essential in that they can be linked to previous directors who are no longer in office to account for the reckless behaviour of those directors towards the company.[212]

The Companies Act[213] sets out a range of actions for which directors may be held liable as a result for any loss, damage or costs sustained by the company. These actions include:

- When a director without the authority of the company acts in the company's name;[214]
- Where there is intent by a director to defraud shareholders, employees or creditors by an act or omission;[215]
- Where misleading and false financial statements were signed off; or[216]
- Where untrue statements are issued about the company.[217]

Section 76(3)[218] deals with the standard of conduct that directors must comply with. This specifically deals with acting in good faith and for proper purpose in the best interest of the company with care, skill and diligence, which is the common law standard.[219] Section 76[220] takes it a step further beyond the common law standard of conduct of care, skills and diligence and

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[211] Section 24(3)(b) (i-ii) of the Companies Act 71 of 2008.
[212] Werkmans Attorneys 'Duties and Liabilities of Directors' available at *https://www.werksmans.com/wp-content/uploads/2013/04/Director-duties-and-liabilities-FINAL-updated-electronic.pdf* (accessed on 15 November 2021).
[213] Act 71 of 2008.
[214] Deloitte. 'The Companies Act: Implications for directors and prescribed officers' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_DirectorsandPrescribedOfficers_16042014.pdf* (accessed on 3 August 2021).
[215] Deloitte. 'The Companies Act: Implications for directors and prescribed officers' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_DirectorsandPrescribedOfficers_16042014.pdf* (accessed on 3 August 2021).
[216] Deloitte. 'The Companies Act: Implications for directors and prescribed officers' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_DirectorsandPrescribedOfficers_16042014.pdf* (accessed on 3 August 2021)..
[217] Deloitte. 'The Companies Act: Implications for directors and prescribed officers' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_DirectorsandPrescribedOfficers_16042014.pdf* (accessed on 3 August 2021).
[218] Section 73(3) of the Companies Act 71 of 2008.
[219] Section 73(3) of the Companies Act 71 of 2008.
[220] Section 76(3)(a-c) of the Companies Act 71 of 2008.

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expects that directors act in the manner which they believe is in reasonable best interests of the company and will provide the most benefit to the company.[221] This goes hand in and hand with ensuring that the directors do not sign or approve false or misleading financial statements or prospectuses.

Where there is failure in this regard, section 77[222] provides that such director will be liable in delict for damages or loss arising from a breach thereof.[223] Section 77(9)(a)[224] of the Act states that if any legal proceedings against a director is taken, whether it be because of willful misconduct or willful breach of trust, the court may relieve the director, either wholly or in part, from any liability if they meet the terms further set out in the section.[225]

Other important sections of the Companies Act[226] regarding the governance of directors are section 214 and section 218.[227] Section 214 (1-4)[228] is important particularly when looking at financial misconduct of directors, as it renders a director guilty of a criminal offence if such director knowingly as a party partakes in activity which results in defrauding or any other fraudulent activity towards a creditor or employee of the company, or a holder of the company's securities.[229] Section 218(1-2)[230] provides that a person can be liable to another if they suffered any loss or damages by the person who contravened the Companies Act,[231] and subsequently provides relief not only to the company but to a third party who had suffered loss.

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Common law liability is another system that governs the duties and responsibilities of directors and is a very important structure within South Africa. I will be discussing this in more detail in paragraph 1.4.3.

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[221] Werkmans Attorneys 'Duties and Liabilities of Directors' available at *https://www.werksmans.com/wp-content/uploads/2013/04/Director-duties-and-liabilities-FINAL-updated-electronic.pdf* (accessed on 15 November 2021).
[222] Section 77(2)(b)(i-iii) of the Companies Act 71 of 2008.
[223] Section 77(2)(b)(i-iii) of the Companies Act 71 of 2008.
[224] Section 77(9)(a) of the Companies Act 71 of 2008.
[225] Section 77(9)(a) of the Companies Act 71 of 2008.
[226] Act 71 of 2008.
[227] Section 214 of the Companies Act 71 of 2008.
[228] Section 218 of the Companies Act 71 of 2008.
[229] Section 214(1-4) of the Companies Act 71 of 2008.
[230] Section 218(1-2) of the Companies Act 71 of 2008.
[231] Act 71 of 2008.

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3.4.1. Memorandum of Incorporation

The Memorandum of Incorporation or the 'MOI' is the most important document that governs the company; it is basically the constitution of the company. It binds the shareholders and directors or prescribed officers.[232] The MOI is a document that is drawn up specifically for the rules that are used to govern the conduct of the company and lays out the authority levels and the respective roles and rights of shareholders and directors.[233] It still relies on the Companies Act[234] to ensure that specific requirements are placed in the MOI to protect the interests of the shareholders. These include a number of default company rules or provisions which companies may accept or alter as they see fit as long as it is in accordance with Act's provisions.[235] When it comes to the direction of a company and what document takes priority, that would be the MIO, as long as it does not conflict with any provisions in the Companies Act.[236]

When reading the Companies Act[237] and then understanding the definition of the MOI, one can see that directors need to act accordingly and carry out their duties to the best of their appointed roles. Each MOI is different for each company and what they require in order with their mission and purpose. As the MOI gives power, number of board members and protection to the board of directors, it also has the power to restrict this power of the directors. In doing so it ensures that the directors do not overstep or abuse their powers.[238]

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3.4.2. Common Law

In terms of common law, many of these principles have been codified into legislation, mainly through the Companies Act; yet it is very important to remember that common law duty of

[232] Giles J 'What is a MOI or Memorandum of Incorporation?' available at *https://www.michalsons.com/blog/what-is-a-moi-memorandum-incorporation/20697* (accessed on 30 July 2021).
[233] Giles J 'What is a MOI or Memorandum of Incorporation?' available at *https://www.michalsons.com/blog/what-is-a-moi-memorandum-incorporation/20697* (accessed on 30 July 2021).
[234] Act 71 of 2008.
[235] Companies and Intellectual Property Commission 'Memorandum of Incorporation (MoI)' available at *http://www.cipc.co.za/index.php/register-your-business/companies/moi/* (accessed on 30 July 2021).
[236] Intergate Immigration 'Memorandum of Incorporation – South Africa' available at *https://www.intergate-immigration.com/memorandum-incorporation-south-africa.php* (accessed on 30 July 2021).
[237] Act 71 of 2008.
[238] Kotze M, De Villiers DW 'Drafting Memorandum of Incorporation (MOI) share structures – Important considerations' available at *https://www.golegal.co.za/drafting-moi-memorandum-incorporation/* (accessed on 30 July 2021).

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directors is not fully codified and it should not be assumed that the Companies Act replaced common law.[239]

There are certain fiduciary duties: this means that a director needs to place the 'interests of the company ahead of their own'.[240] This includes acting in the best interest of the company, not acting beyond or exceeding the limitations of their powers or capacity, not finding themselves in a conflict of interest, not making any secret profits or incidental profits at the expense of the company, not disclosing any personal interests, and not misappropriating corporate opportunities.[241] In the case of *CyberScene Ltd and others v iKiosk Internet and Information (Pty) Ltd*,[242] it was held that even though a director is a non-executive directors they are still considered to have a fiduciary relationship to the company.[243]

Another important common law duty is that a director needs to have a duty of skill, care and diligence when it comes to acting in their scope of the company. This specific duty can be seen codified in the Companies Act,[244] under section 76(3)(c)(i) and (ii).[245] This means that when a director is appointed, it is for the skills, knowledge or experience that they have; therefore they must give the company the benefit of those skills, knowledge and experience.[246]

3.4.3. King Code IV

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As mentioned, the King Code is voluntary, which means that it only serves as a company guide on good corporate governance, expect companies that are listed on the JSE; for them the King Code

[239] Institute of Directors Southern Africa 'General Guidance Note Directors' Duties' available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/General_Guidance_Note_on_Directors'_Duties.pdf* (accessed on 30 July 2021).
[240] Corplaw 'Directors' Duty Of Care & Skill In The Conduct Of Company Business' available at *https://blog.corplaw.ie/bid/390945/directors-duty-of-care-skill-in-the-conduct-of-company-business* (accessed on 30 July 2021).
[241] Institute of Directors Southern Africa 'General Guidance Note Directors' Duties' available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/General_Guidance_Note_on_Directors'_Duties.pdf* (accessed on 30 July 2021).
[242] 2000 (3) SA 806 (C).
[243] *CyberScene Ltd and others v iKiosk Internet and Information (Pty) Ltd* 2000 (3) SA 806 (C).
[244] Act 71 of 2008.
[245] Section 76(3)(c)(i) and (ii) of the Companies Act 71 of 2008.
[246] Maharaj N *A discussion on the duty of care, skill and diligence to be exercised by a director in light of the Companies Act 71 of 2008, as well as the common law and an overview of the business judgment rule: A company law perspective* (unpublished LLM thesis, University of KwaZulu-Natal,2015) pg. 19.

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is compulsory.[247] Its universal application is a milestone, as most companies may use King's principles to effect good and proper corporate governance, specifically when looking at directors.[248] This shows the relationship between the King Code IV and the importance of corporate governance; according to King IV, the application of corporate governance is 'one of the key principles in King IV is the establishment of a unitary board which reflects a balance of power'.[249]

Under King IV, 17 principles listed for good corporate governance apply to directors and the governance of a company:

- The governing body should ensure that the manner they govern in does not only ensure that they are responsible corporate citizens but also that the governance is ethical and effective and supports the establishment of an ethical culture.[250]
- For the stakeholders to be able to make informed decisions for the companies short-, medium- and long-term prospects, the governing body should ensure they provide the stakeholders with an accurate report of the company's performance.[251]

- The governing body needs to ensure that the company complies with laws, non-binding rules, codes and standards that ensure that a company carries out good corporate governance.[252]

- There should be a fair and equal distribution of knowledge, skill, experience, diversity and independence among the governing body when they act within the scope of the role and carry out their duties and responsibilities.[253]

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[247] Smith N (2017) The JSE Limited Listings Requirements.
[248] Institute of Directors Southern Africa 'General Guidance Note Board Composition' available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/General_Guidance_Note_on_Board_Composition.pdf* (accessed on 30 July 2021).
[249] Deloitte. 'Duties of Directors' available at https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_Duties-Of-Directors_101017.pdf (accessed on 2 August 2021).
[250] Institute of Directors Southern Africa (2016) King IV: Report on Corporate Governance for South Africa pg. 40.
[251] Institute of Directors Southern Africa (2016) King IV: Report on Corporate Governance for South Africa pg. 40.
[252] Institute of Directors Southern Africa (2016) King IV: Report on Corporate Governance for South Africa pg. 41.
[253] Institute of Directors Southern Africa (2016) King IV: Report on Corporate Governance for South Africa pg. 41.

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- When it comes to risk management regarding technology and information or in achieving strategic objectives, the governing body needs to ensure they make correct and informed decisions that support the company.[254]

An important case when looking at the implementation of these principles is *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Company Limited and others*.[255] In this matter there was a direct reference to the King Code, and importance was placed on the duties of directors that the Code has provided; it was stated that where one director has failed a duty, it needs to be applied as though all directors have failed the duty towards the company.[256]

3.4.4. Johannesburg Stock Exchange (JSE)

The JSE Listing Requirements are only applicable to companies that are listed companies under the JSE. Though the JSE is governed by both the Stock Exchanges Control Act[257] and the Financial Markets Control Act,[258] it is 'privately owned and is funded and governed by a board of directors'.[259] The JSE ensures that when operating in markets it does so in a transparent manner and ensures that there is investor protection and that relevant information is sufficiently disclosed to all investors.[260]

The JSE Listing Requirements is an extensive document that provides definitions for executive, non-executive and independent directors. This document also stresses the fact that to ensure that there is no director with uninhibited power when it comes to decision-making, policies need to be established to show a clear balance of power and authority at the board of directors' level.[261] It

[254] Institute of Directors Southern Africa (2016) King IV: Report on Corporate Governance for South Africa pg. 41.
[255] (7655/05, 7655/05) [2006] ZAGPHC 47 (15 May 2006).
[256] *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Company Limited and others* (7655/05, 7655/05) [2006] ZAGPHC 47 (15 May 2006).
[257] Act 1 of 1985.
[258] Act 55 of 1989.
[259] Joburg 'Johannesburg Securities Exchange (more)' available at *https://www.joburg.org.za/work_/Pages/Work%20in%20Joburg/Key%20Sectors/Links/More.aspx* (accessed on 1 August 2021).
[260] Joburg: 'Johannesburg Securities Exchange (more)' available at *https://www.joburg.org.za/work_/Pages/Work%20in%20Joburg/Key%20Sectors/Links/More.aspx* (accessed on 1 August 2021).
[261] Deloitte. 'Duties of Directors' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_Duties-Of-Directors_101017.pdf* (accessed on 2 August 2021).

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further states that if there is any new director appointment, a director resigns, is removed from the board, or instance such as if there is a 'change of important functions on the board, or change of executive responsibilities of a director', then the JSE needs to be informed of this by the end of that business day or a notice of change needs to be sent. This does not apply to a director that retires by rotation and is re-appointed.[262] This document also provides that when a company is listed on it, it gets listed under a schedule; this is applicable to the operations of that company – under schedule 10, a company needs to at least appoint four directors.[263]

Now that I have unpacked the legislation and rules that govern the duties and responsibilities of directors, I can delve into the concept of directors' accountability, with the focus on the importance of the financial literacy of a director.

3.5. Directors Accountability

In the previous chapter, I spoke about director misconduct and showed different cases that highlighted where directors of the company who were meant to act in its best interest failed to do so. I focused on misconduct which is financially related. I did this in order to highlight that law places requirements on directors to have financial understanding when they are appointed to the board. This brought up the question of whether it should be a requirement for a director to be financial literate. Should it only be required in the MOI? Or should the Companies Act ensure that requirements are made for directors to ensure that the MOI can take its director from there? I will now explore what I mean by financial literacy of directors and how directors should be held accountable for the lack thereof when dealing with financial statements of a company. I will examine the business judgment rule and how it could protect directors when trying to hold them accountable.

3.5.1. Directors' Financial Literacy Relationship with Corporate Governance and Business Ethics

Under directors duties, I explained that directors deal with financial statements of the company, which is not only used to inform shareholders of the financial standing of the company but is also used to strategically plan for the future. When a director is well versed in understanding financial

[262] LexisNexis: JSE Limited Listings Requirements.
[263] LexisNexis: JSE Limited Listings Requirements.

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statements, even though they are not the ones who are responsible for producing these statements, they should be able to decipher them and detect potential problems, as they are the ones that approve them.[264] Having basic financial literacy is a fiduciary duty that can be applied to directors, as those directors who are financially literate are able to understand the company's financial performance better and thus make decisions that are in good faith and in the best interest of the company's future development.[265]

There are various problems that the board needs to pick up between the lines when reading financial statements:

- **Sales manipulation:** This type of manipulation can come in the form of recording sales before they have been made, recording deliveries to storage owners, dealers or independent representatives as sales or creating sales that were never made. Since a company survives off its income, it is important that these are recorded correctly alongside the expenses.[266]

- **Expense manipulation:** In order to ensure how much profit a company is making, it is important to correctly show how much money a company is giving out in order to carry on its business. Manipulation can come in the form of showing normal operating expenses as capital, recording current expenses for a future dated period to show profits increasing, or booking future expenses in the current period to create the appearance that future earnings have increased.[267]

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[264] Professor Cossin D, Hongze Lu A, IMB 'A note on Finance Essentials for Directors' available at *https://www.imd.org/research-knowledge/articles/a-note-on-finance-essentials-for-directors/* (accessed on 8 December 2021).
[265] Professor Cossin D, Hongze Lu A, IMB 'A note on Finance Essentials for Directors' available at *https://www.imd.org/research-knowledge/articles/a-note-on-finance-essentials-for-directors/* (accessed on 8 December 2021).
[266] Professor Cossin D, Hongze Lu A, IMB 'A note on Finance Essentials for Directors' available at *https://www.imd.org/research-knowledge/articles/a-note-on-finance-essentials-for-directors/* (accessed on 8 December 2021).
[267] Professor Cossin D, Hongze Lu A, IMB 'A note on Finance Essentials for Directors' available at *https://www.imd.org/research-knowledge/articles/a-note-on-finance-essentials-for-directors/* (accessed on 8 December 2021).

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- **Incorrect asset valuation:** Not recording the full cost of all materials, not reporting a proper depreciation of fixed assets, or misreporting current inventory are all forms of incorrect asset valuation.[268]

One of the most important problem that needs to be detected is when directors or audit committee members are unethically pocketing money that does not belong to them but to the company. An example of this can be seen in the Steinhoff case, where Markus Jooste would reward himself with undeclared bonuses and gave himself a loan.[269]

It is important to note that though not all members on the board of directors need to be a financial experts, it is at least expected that they should have some basic financial literacy, including being able to read and evaluate financial statements, as well knowing what questions to ask to be able to know the financial standing of the company.[270] Once a director knows what they are reading in regard to financial statements, they can ensure that the statements are balanced, fair and not misleading.[271] This thus ensures that they are also not held accountable for any fraudulent activity that could be happening in the company. A director ensuring that they have some sort of financial literacy is vital, especially when it comes to a larger board of directors – all directors are responsible for correct financial reporting.[272]

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It is important to examine corporate governance and its relationship with ensuring that directors have financial literacy. With the board being one of the most important role-players in the company that ensure that the company practices good corporate governance, it needs to ensure that its actions are in line with these practices.

[268] Professor Cossin D, Hongze Lu A, IMB ‘A note on Finance Essentials for Directors’ available at *https://www.imd.org/research-knowledge/articles/a-note-on-finance-essentials-for-directors/* (accessed on 8 December 2021).
[269] Business Insider SA ‘The biggest South African business scandals over the past decade’ available at *https://www.businessinsider.co.za/the-top-south-african-business-scandals-the-past-decade-2020-1* (accessed on 15 November 2021).
[270] DC Bar Pro Bono Center (2015) ‘The Role of the Board of Directors in Financial Oversight: A Guide for Board Members’ pg. 5.
[271] ACCA ‘Directors responsibilities for financial reporting: What you need to know’ available at *https://www.accaglobal.com/an/en/technical-activities/technical-resources-search/2017/november/directors-responsibilities-for-financial-reporting.html* (accessed on 4 August 2021).
[272] Tugman L, Leka L ‘5 Key Factors to Enhance Audit Committee Effectiveness’ available at *https://www.ifac.org/knowledge-gateway/supporting-international-standards/discussion/5-key-factors-enhance-audit-committee-effectiveness* (accessed on 2 August 2021).

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Business ethics places the standard on the board of directors to be able to determine what is correct and incorrect when performing their duties and responsibilities towards the company. Understanding financial statements helps ensure that directors notice errors or fraudulent activity to protect themselves and the company and ensure that those who committed these can be held accountable.

3.5.2. Directors Accountability for Lack of Financial Literacy in South Africa and Protection Provided by South African Legislation

Knowing how directors can be held accountable where it comes to financial misconduct and how this can be prevented by ensuring they have financial literacy is important. It will also help to determine whether the Companies Act[273] needs to be updated to incorporate these principles or where it should be just placed in the MOI.

As stated above, there are no requirements for who may be appointed as directors; this is then left up to the board of directors and the vision and mission of the company. Though the MOI, they may make provision to provide protection to directors, but this is not always the case. Under the Companies Act,[274] there are many examples that warrant the removal and disqualification of a director for misconduct, such as section 69[275] (ineligibility and disqualification of persons to be directors or prescribed officers), section 70[276] (directors' personal financial interest), section 71[277] (removal of directors), section 76[278] (standards of directors' conduct), section 77 (liability of directors and prescribed officers) and section 162[279] (application to declare director delinquent or under probation). These will all attract criminal and civil liability.[280]

Even though protection is provided for directors where they do fail their duties, they can be held liable. This can be seen in *Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty)*

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273 Act 71 of 2008.
274 Act 71 of 2008
275 Section 69 of the Companies Act 71 of 2008.
276 Section 70 of the Companies Act 71 of 2008.
277 Section 71 of the Companies Act 71 of 2008.
278 Section 76 of the Companies Act 71 of 2008.
279 Section 162 of the Companies Act 71 of 2008.
280 Institute of Directors South Africa 'Director Misconduct: General guidance note on how to approach director misconduct' available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/IoDSA_Guidance_for_Boards_-_Director_Misconduct.pdf* (accessed on 4 August 2021).

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Ltd.[281] The Court held that a director is not expected to have the qualifications or expertise of an auditor or an accountant, but as they (all the members of the board of directors) are equally given the obligation to approve the financial statements of the company, they need to do so by exercising reasonable care expected from them taken into account their knowledge and experience.[282] With that being said, directors are not liable for mere errors in judgment; also, if a directors accepts the information and advice of management that they have been provided, that is also not an error; this though must not be accepted blindly, but with due consideration and exercising his/her own judgment when doing so.[283]

Cases such as this show that a director cannot just blindly rely on the information that he/she is provided with by the audit committee[284] and use that as an excuse for not carrying out his/her duties with the expected care and diligence. He/she should rather take their time to go through all the relevant documentation and ensure that the content of the report is correct and coincides with his/her view of the position of the company.[285]

A director should be held liable for not having basic financial literacy when dealing with financial statements as it is a key part of their duties and responsibilities. Taking on the role of director, one takes on the duties that come with that. It should be mentioned that with there being provisions that warrant the removal or disqualifications of a director, the Companies Act[286] also has various sections that allow a director reasonable scope of action in their duties without a fear that they will open themselves up to liability claims. One of these sections is section 78[287](indemnification and directors' insurance), which allows for a company to take out indemnity insurance to protect a

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[281] 1980 (4) SA 156 (W).
[282] *Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd* 1980 (4) SA 156 (W).
[283] *Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd* 1980 (4) SA 156 (W).
[284] Institute of Directors South Africa 'Director Misconduct: General guidance note on how to approach director misconduct' available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/IoDSA_Guidance_for_Boards_-_Director_Misconduct.pdf* (accessed on 4 August 2021).
[285] Institute of Directors South Africa 'Director Misconduct: General guidance note on how to approach director misconduct available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/IoDSA_Guidance_for_Boards_-_Director_Misconduct.pdf* (accessed on 4 August 2021).
[286] Act 71 of 2008.
[287] Section 78 of the Companies Act 71 of 2008.

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director given that they are not convicted of the offence; it provides not only protection for the director but for the company as well.[288]

Another one of these protections is the business judgment rule. The Companies Act[289] has codified the business judgment rule under section 76(4).[290] It has resulted in the potential for directors to be indemnified in some circumstances, as well as the firm and its directors being insured against legal liability in certain instances.[291] The business judgment rule is used to protect directors against liability for their decisions when they act in good faith and with reasonable diligence.[292] The concept originated in the United States and was adopted by South Africa. Its application can be seen in the *re Walt Disney Derivative Litigation,*[293] which is a USA court matter, where a Walt Disney Company shareholder brought an action against the board of directors who they believed breached their fiduciary duty by hiring a chief operating officer and then dismissed him 14 months later with a termination package of 140 million dollars.[294] The Court held that the directors had exercised their sound business judgment, as the Court cannot decided if they were reasonable within the context of their scope of their duty.[295]

When looking at this rule in relation to directors having financial literacy, the Act states that this rule does not protect directors who did not to take reasonable steps to be informed about the matter in front of them, which would include the financial statements.[296]

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3.6. Role of the Board of Directors in Different Countries and Financial Literacy Implementation

[288] Smith W, Loubser T 'Companies Act 2008 – Directors' Responsibilities and Liability' available at *https://www.exceed.co.za/companies-act-2008-directors-responsibilities-and-liability/?cn-reloaded=1* (accessed on 3 August 2021).
[289] Act 71 of 2008.
[290] Section 76(4) of the Companies Act 71 of 2008.
[291] Deloitte. 'The Companies Act: Implications for directors and prescribed officers' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_DirectorsandPrescribedOfficers_16042014.pdf* (accessed on 3 August 2021).
[292] Wiese T 'Corporate Governance in South Africa with International Comparisons' (2014) pg. 137.
[293] Case No 411, 2005 (Del June 8, 2006).
[294] *re Walt Disney Derivative Litigation* Case No 411, 2005 (Del June 8, 2006).
[295] *re Walt Disney Derivative Litigation* Case No 411, 2005 (Del June 8, 2006).
[296] Wiese T 'Corporate Governance in South Africa with International Comparisons' (2014) pg. 138.

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Looking at other countries and how they implement and govern financial literacy gives perspective on things that South Africa can use to implement better financial literacy requirements for directors. It is also important to look at other countries and their application, as the Companies Act[297] does state that when a Court is dealing with a matter and interpreting and applying the sections of the Companies Act,[298] it may consider foreign company law.

3.6.1. Australia

In Australia, the duties of directors are governed under the Corporations Act.[299] It makes mention that a director has to maintain their duty of care, skill and diligence to the company, and that they are accountable to the shareholders.[300]

A prime example of how Australia ensures that directors act in accordance with their duties with regarding financial literacy is the case of *Australian Securities and Investments Commission v Healey*,[301] also known as the Centro case. In this case, there were allegations by the Australian Securities and Investments Commission that sections of the Corporations Act[302] were contravened by members (non-executive Chairman, six other non-executive directors and the Chief Financial Officer) of the Centro Property Group (Centro).[303] This included that they approved 'financial statements of Centro, which incorrectly reflected substantial short-term borrowings as 'non-current liabilities'.[304] The main question that arose out of this matter was whether directors are required to apply their own minds when reviewing financial statements of a company and that when the directors' report back, they disclose all information and do not omit any material

297 Act 71 of 2008.
298 Act 71 of 2008.
299 Act 2001.
300 ACCA 'Directors responsibilities for financial reporting: What you need to know' available at *https://www.accaglobal.com/an/en/technical-activities/technical-resources-search/2017/november/directors-responsibilities-for-financial-reporting.html* (accessed on 4 August 2021).
301 [2011] FCA 717.
302 Act 2001.
303 *Australian Securities and Investments Commission v Healey* [2011] FCA 717.
304 Institute of Directors South Africa 'Director Misconduct: General guidance note on how to approach director misconduct' available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/IoDSA_Guidance_for_Boards_-_Director_Misconduct.pdf* (accessed on 4 August 2021).

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information.[305] In essence, this question is about to 'what extent non-executive directors may place reliance on the audit committee and the finance team'.[306]

Once the Court looked at all the facts it held that the degree of care and diligence that is required by law towards the company was not met by the directors when they were reviewing financial statements; they were therefore held liable for the loss suffered by the company.

3.6.2. United States of America

In the United States, the Sarbanes-Oxley Act[307] comes into play as it governs the actions of directors. The Act resulted in the following:

- New rules for corporations were put in place, such as placing new standards for the auditors to ensure that better handling of financial statements is done.[308]
- It enhanced the disclosure requirements, such as disclosing material off-balance sheet arrangements.[309]
- It imposes harsher criminal penalties for matters dealing with fraud and ensures that directors and officers become personally liable for the accuracy of financial statements.[310]

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These countries show that they understand the need for directors to have financial literacy to ensure that financial misconduct can be better avoided.

[305] *Australian Securities and Investments Commission v Healey [2011] FCA 717.*
[306] Institute of Directors South Africa 'Director Misconduct: General guidance note on how to approach director misconduct' available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/IoDSA_Guidance_for_Boards_-_Director_Misconduct.pdf* (accessed on 4 August 2021).
[307] Act 2002.
[308] Blokhin A 'The Impact of the Sarbanes-Oxley Act of 2002' available at *https://www.investopedia.com/ask/answers/052815/what-impact-did-sarbanesoxley-act-have-corporate-governance-united-states.asp* (accessed on 4 August 2021).
[309] Blokhin A 'The Impact of the Sarbanes-Oxley Act of 2002' available at *https://www.investopedia.com/ask/answers/052815/what-impact-did-sarbanesoxley-act-have-corporate-governance-united-states.asp* (accessed on 4 August 2021).
[310] Blokhin A 'The Impact of the Sarbanes-Oxley Act of 2002' available at *https://www.investopedia.com/ask/answers/052815/what-impact-did-sarbanesoxley-act-have-corporate-governance-united-states.asp* (accessed on 4 August 2021).

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3.7. Chapter Conclusion

Within this chapter the focus was on the board of directors and their importance. I emphasized the different types of directors that are recognized by the Companies Act[311] and those that are not. This showcased the different roles that directors play on the board. The focus then shifted onto the governing legislation and how this ties up with the importance of having fixed requirements for the board of directors. The importance of ensuring that directors have financial literacy was also discussed in relation to case law, where emphasis was placed on directors acting in a particular manner. Finally, it was important to show how other countries impose legislation on their directors, particularly with reference to financial literacy. I also posed the question of whether the requirement for financial literacy of directors should be added within the Companies Act[312] or whether it should just be requirements that companies place within their MOI.

Looking at all the information that was presented, I believe that the Companies Act[313] should be revised in order to make provisions for directors' requirements in order to be appointed. Though the MOI and the discretion of the board can enable this when making new appointments, it makes it a lot easier to have a standard that is followed, as the MOI takes its standard from the Companies Act.[314] I will be examining a further role-player in the financial statements of the company in chapter 4, the audit committee.

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[311] Act 71 of 2008.
[312] Act 71 of 2008.
[313] Act 71 of 2008.
[314] Act 71 of 2008.

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4. Chapter 4: Audit Committee

4.1. Introduction

In the previous chapter I discussed the role of directors and the importance of their having financial literacy in order to ensure that financial misconduct can be combatted. Within this chapter I will explore another role-player that deals with the financial records and reporting of the company, which is the audit committee. I will be exploring its role within their company and the relationship that it has with the board of directors. I will further discuss its importance when dealing with the financial statements of a company and how and what legislation regulates this. I will then focus on the role that the audit committee plays when it comes to corporate governance and business ethics, as well as provide examples of financial misconduct committed by the audit committee. After this I will explore the financial literacy requirements placed on the audit committee by South Africa as well as the accountability applicable to those who do not adhere to these requirements. I will conclude by showing the importance other countries place on the audit committee being financially literate.

4.2. Audit Committee

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The audit committee plays a very important role in the governance of a company, particularly comes to the management and reliability of the financial reporting for the company.[315] The concept of an audit committee in a company is not a new development, but the emphasis of its importance has been on the rise in the last few years.[316] The first audit committee was established in the United Kingdom as early as the 1872 by the Great Western Railway Company.[317] There are various reasons as to why there has been a growth in the importance placed on the audit committee. In South Africa there is legislation in place to ensure proper governance, including the duties and responsibilities of audit committees.[318] The role of the audit committee is vital to ensure the

[315] Dr Al-Baidhani AM 'The Nature of a Dynamic Relationship between Audit Committee and Auditors, both Internal and External' (2016) 07 *Business and Economics Journal* pg. 2.
[316] Tugman L, Leka L '5 Key Factors to Enhance Audit Committee Effectiveness' available at *https://www.ifac.org/knowledge-gateway/supporting-international-standards/discussion/5-key-factors-enhance-audit-committee-effectiveness* (accessed on 2 August 2021).
[317] Marx B. *An Analysis of the Development, Status and Function of Audit Committee at Largest Listed Companies in South Africa* (unpublished Doctorate Commercii thesis, University of Johannesburg, 2008) pg. 13.
[318] Marx B. *An Analysis of the Development, Status and Function of Audit Committee at Largest Listed Companies in South Africa* (unpublished Doctorate Commercii thesis, University of Johannesburg, 2008) pg. 229.

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'effectiveness of the company's functions and services, with particular focus on external service providers, internal audit and the finance function, and the integrity of the annual financial statements and other external reports issued by the company'.[319] It is therefore important to explore how the audit committee is made up, as well as the relationship that it has with the board of directors.

4.2.1. <u>Composition of the Audit Committee</u>

When it comes to the audit committee, it is governed by legislation, such as the Companies Act[320] and codes like the King Code IV. These govern how the audit committee needs to be composed: it needs to be made up of at least three independent non-executive directors, with the emphasis on the fact that they must be directors of the company.[321] If an audit committee has less than three members, then it does not meet the statutory requirements as per the Companies Act[322] and cannot be classified as an audit committee.[323] The importance of the independence is vital when it comes to the audit committee and therefore its independence should be reviewed by the company annually or more often as necessary.[324] Having a smaller audit committee can be beneficial for certain companies as it allows for these three members to be able to tackle all their responsibilities; but sometimes a larger audit committee is more efficient. A larger audit committee allows for the members to have more skills and experience and inevitably helps enhance the quality of the discussions, decisions as well as ensuring that there is effective succession planning and rotation

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319 Delottie. 'Audit Committee Resource Guide' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/audit/za_ACRG_Revised.pdf* (accessed on 7 September 2021).
320 Act 71 of 2008.
321 Delottie. 'The Audit Committee Report: Analysing the trends in South Africa' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/audit/za_Deloitte_The_Audit_Committee_Report_240418.pdf* (accessed on 21 September 2021).
322 Act 71 of 2008.
323 Delottie. 'The Audit Committee Report: Analysing the trends in South Africa' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/audit/za_Deloitte_The_Audit_Committee_Report_240418.pdf* (accessed on 21 September 2021).
324 Delottie. 'Audit Committee Resource Guide' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/audit/za_ACRG_Revised.pdf* (accessed on 7 September 2021).

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when a member resigns or is removed from the audit committee.[325] Under the Companies Act,[326] it is also provided that there needs to be regular rotation of auditors on the audit committee and that no auditor on the committee may serve in the position for the company for a period of more than five consecutive financial years.[327]

Exploring the types of auditors that one finds within a company is vital, because they work hand in glove with the audit committee to ensure the strength and growth of the company.

4.2.2. Types of Auditors

The audit committee acts as a link between the board of directors and both internal and external auditors in order to ensure the success of the company.[328]

4.2.2.1. Internal Auditors

Internal auditors act as the right hand of the board of directors through the audit committee. They are defined by the Institute of Internal Auditors as independent persons who assist a company by bringing about 'a systematic, disciplined approach to evaluate and improve the effectiveness of the risk management, control and governance'[329] of that company. Even though the work of internal auditors is focused on assisting the company with its financial records, they add value to the company by being a source of objective independent advice to both the board of directors and to senior management.[330]

4.2.2.2. External Auditors

[325] Delottie. 'The Audit Committee Report: Analysing the trends in South Africa' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/audit/za_Deloitte_The_Audit_Committee_Report_240418.pdf* (accessed on 21 September 2021).
[326] Act 71 of 2008.
[327] Deloitte. 'Audit Committee Resource Guide' available at *https://www2.deloitte.com/za/en/pages/audit/articles/audit-committee-resource-guide.html* (accessed on 21 September 2021).
[328] Dr Al-Baidhani AM 'The Nature of a Dynamic Relationship between Audit Committee and Auditors, both Internal and External' (2016) 07 *Business and Economics Journal* pg. 2.
[329] Cascarino R & van Esch S *Internal Auditing: An Integrated Approach* 2 ed (2005) pg. 5.
[330] The Institute of Internal Auditors 'Value Proposition: Internal Auditing's Value to Stakeholders' available at *https://na.theiia.org/about-us/about-ia/pages/value-proposition.aspx* (accessed on 22 November 2021).

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External auditors play an important role when it comes to the governance of a company, as in order to effectively critique the company's internal processes, one needs to take an objective standpoint.[331] With internal auditors or internal accounting working closely with the everyday business of a company, this becomes impossible to do and that is where external auditors come into play, as they have the ability to reshape the conduct of the company without there being the fear of any retaliation.[332] External auditors are independent third parties that have no association with the company and are used to verify the financial statements of the company.[333] Like internal auditors, external auditors examine the accounting books, payroll, purchasing records, and other financial reports of the company so that they are able to spot red flags and report it.[334]

4.2.2.3. Differences between Internal and External Auditors

The table below shows the roles that the different types of auditors play role within a company.

	Internal Auditors	**External Auditors**
Mandate	Internal auditors work through the audit committee and report to the board of directors.[335]	The duty of external auditors is a statutory obligation towards the shareholders and the public.[336]

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[331] Intergate Immigration 'External Auditors – The Importance of' available at *https://www.intergate-immigration.com/external-auditors.php* (accessed on 15 September 2021).
[332] Intergate Immigration 'External Auditors – The Importance of' available at *https://www.intergate-immigration.com/external-auditors.php* (accessed on 15 September 2021).
[333] Satka E 'Internal and External Audit in the Function of the Management of the Trade Companies' (2017) 14 *Journal of US-China Public Administration* pg. 331.
[334] Top Accounting Degrees 'What is an External Auditor?' available at *https://www.topaccountingdegrees.org/faq/what-is-an-external-auditor/* (accessed on 16 September 2021).
[335] Satka E 'Internal and External Audit in the Function of the Management of the Trade Companies' (2017) 14 *Journal of US-China Public Administration* pg. 332.
[336] Satka E 'Internal and External Audit in the Function of the Management of the Trade Companies' (2017) 14 *Journal of US-China Public Administration* pg. 336.

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Area of Focus	All departments, aspects and functions of the company are the focus of the internal auditors.[337]	Finances and accounting are the primary focus of the external auditors towards the company.[338]
Independence	Internal auditors are independent of management, and they provide internal audit assurance and report to the audit committee.[339]	External auditors have a statutory obligation to the company and therefore provide independent external assurance.[340]

I will now explore the relationship that the audit committee has with the board of directors and the duties that it has towards the audit committee.

4.3. Relationship between the Board of Directors and the Audit Committee

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The board of directors and audit committee, though they are two sperate independent bodies, work very closely with each other.[341] The audit committee is seen as a representative of the board of directors. The audit committee works to ensure that the company's financial records and reporting are accurate and there is compliance with the relevant regulations and ethical standards of the company (these ethical standards include the internal auditors being independent and competent

337 Delottie. 'The Audit Committee Report: Analysing the trends in South Africa' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/audit/za_Deloitte_The_Audit_Committee_Report_240418.pdf* (accessed on 21 September 2021).
338 Delottie. 'The Audit Committee Report: Analysing the trends in South Africa' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/audit/za_Deloitte_The_Audit_Committee_Report_240418.pdf* (accessed on 21 September 2021).
339 The Institute of Internal Auditors South Africa 'What do Internal Auditors do?' available at *https://www.iiasa.org.za/page/About_IA* (accessed on 10 September 2021).
340 The Institute of Internal Auditors South Africa: What do Internal Auditors do? available at *https://www.iiasa.org.za/page/About_IA* (accessed on 10 September 2021).
341 Deloitte. 'The Role of the Audit Committee available at *https://www2.deloitte.com/content/dam/Deloitte/us/Documents/center-for-board-effectiveness/us-audit-committee-resource-guide-section-2.pdf* (accessed on 16 September 2021).

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and that all compensation paid to the board of directors is reasonable and appropriate).[342] They do all of this while reporting to the board of directors.

The audit committee will either meet with the board of directors quarterly or more frequently, depending on the circumstances, to inform them of the audit plans, audit findings or anything that they deem to be important to the board of directors.[343] As mentioned, the audit committee assists the board of directors in overseeing the financial standing of the company. This entails, inter alia, the following duties and activities:

- Ensuring that all financial information is disclosed and that the financial statements are reliable when presented.[344]
- Ensuring that risk management systems exist and that there is effective internal control of the company.[345]
- Ensuring compliance with legal and regulatory requirements.[346]
- Ensuring that the external auditors appointed to the company are qualified, independent and perform the duties expected of them.[347]
- Performing the duties and activities that are expected of internal auditors.[348]

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[342] Dr. Al-Baidhani AM 'The Nature of a Dynamic Relationship between Audit Committee and Auditors, both Internal and External' (2016) 07 *Business and Economics Journal* pg. 8.
[343] Companies and Intellectual Property Commission 'Appointment of Audit Committee' available at *http://www.cipc.co.za/index.php/manage-your-business/manage-your-company/public-company/compliance-obligations/appointment-audit-committee/* (accessed on 7 September 2021).
[344] Protiviti KnowledgeLeader 'Audit Committee: Importance to the Board of Directors' available at *https://info.knowledgeleader.com/audit-committee-importance-to-the-board-of-directors* (accessed on 7 September 2021).
[345] Protiviti KnowledgeLeader 'Audit Committee: Importance to the Board of Directors' available at *https://info.knowledgeleader.com/audit-committee-importance-to-the-board-of-directors* (accessed on 7 September 2021).
[346] Protiviti KnowledgeLeader 'Audit Committee: Importance to the Board of Directors' available at *https://info.knowledgeleader.com/audit-committee-importance-to-the-board-of-directors* (accessed on 7 September 2021).
[347] Protiviti KnowledgeLeader 'Audit Committee: Importance to the Board of Directors' available at *https://info.knowledgeleader.com/audit-committee-importance-to-the-board-of-directors* (accessed on 7 September 2021).
[348] Protiviti KnowledgeLeader 'Audit Committee: Importance to the Board of Directors' available at *https://info.knowledgeleader.com/audit-committee-importance-to-the-board-of-directors* (accessed on 7 September 2021).

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Now that I have explained the relationship that the audit committee has with the board of directors and the duties that they assist the board of directors with, I can explore the duties and responsibilities of the audit committee in their role within the company.

4.4. Role of the Audit Committee (Duties and Responsibilities)

An audit committee has an important function within a company.

4.4.1. Oversight of Financial Reporting and Internal Controls

With the audit committee having the role and responsibility of oversight and monitoring of the company, they at times need to rely on assistance from management, independent auditors, and any advisers the committee may need in order to carry out this duty.[349] The 'audit committee is responsible for overseeing the entire financial reporting process'[350] of the company and providing financial advice to the board of directors. This responsibility has been a task that has been given to the audit committee for a while; their job is to ensure that the company's financial reports are all accurate.[351] This includes watching over the internal controls of the company, which includes the mechanisms, rules, and procedures implemented by a company to ensure the integrity of financial and accounting information.[352] This results in an adequate reduction in risk and in reliable reporting information.[353]

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4.4.2. Risk oversight and Internal Controls

Another important duty that the audit committee undertakes is to review and manage a company's risk management systems. The audit committee needs to establish the mission of the company, its

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349 Deloitte. 'The Role of the Audit Committee available at *https://www2.deloitte.com/content/dam/Deloitte/us/Documents/center-for-board-effectiveness/us-audit-committee-resource-guide-section-2.pdf* (accessed on 16 September 2021).

350 KPMG 'The Audit Committee's Oversight Role on Financial Reporting 2013' available at *https://assets.kpmg/content/dam/kpmg/pdf/2016/03/20140701_aci-oversight-2013.pdf* (accessed on 15 September 2021).

351 KPMG 'The Audit Committee's Oversight Role on Financial Reporting 2013' available at *https://assets.kpmg/content/dam/kpmg/pdf/2016/03/20140701_aci-oversight-2013.pdf* (accessed on 15 September 2021).

352 Kenton W 'Internal Controls' available at *https://www.investopedia.com/terms/i/internalcontrols.asp* (accessed on 16 September 2021).

353 Public Sector Audit Committee Forum 'Audit Committee Reporting' available at *https://cdn.ymaws.com/www.psacf.co.za/resource/collection/FDA73195-0CB8-46C8-8B58-6EDBEA3A4055/Audit_Committee_Reporting_website_version.pdf* (accessed on 16 September 2021).

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commitments and the objectives it aims to achieve safely and reliably.[354] The main risks to the company are properly identified and further managed and disclosed.[355] Risks include competition, environmental, financial, legal, operational, regulatory, strategic, fraud, compliance and technological (cyber risks).[356] It previously fell to a risk committee to ensure that there was no conflict, as the audit committee is not only made up of board members but works very closely with the board of directors.[357] This has subsequently changed, as the JSE Listing Requirements has now allowed for the two committees to be joined, given that they both meet stringent independence criteria.[358]

4.4.3. <u>Interaction with the External Auditor</u>

When it comes to the audit committee duty and interaction towards the external auditor, they play a major role by not only selecting the auditor but ensuring that the external audit remains independent without any conflict of interest that will affect the external auditor's report.[359] This appointment is done in terms of section 94.[360] An external auditor will submit their proposal to the audit committee, who then takes the proposals and reports what the external auditors have found and suggested to the board of directors; the board will then decide who they feel is best fit to perform the external audit of the company.[361] The audit committee also determine the fees that need to be paid to the external auditors.[362] Both the audit committee and external auditors play a

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[354] KPMG 'Audit Committee Handbook: Audit Committee Institute' available at *https://assets.kpmg/content/dam/kpmg/no/pdf/2017/11/ie-aci-handbook-2017.pdf* (accessed on 21 September 2021).
[355] KPMG 'Audit Committee Handbook: Audit Committee Institute' available at *https://assets.kpmg/content/dam/kpmg/no/pdf/2017/11/ie-aci-handbook-2017.pdf* (accessed on 21 September 2021).
[356] Kloman HF 'The Audit Committee and Its Expanding Role in Risk Management' available at *https://nonprofitrisk.org/resources/articles/the-audit-committee-and-its-expanding-role-in-risk-management/* (accessed on 21 September 2021).
[357] Delottie. 'The Audit Committee Report: Analysing the trends in South Africa' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/audit/za_Deloitte_The_Audit_Committee_Report_240418.pdf* (accessed on 21 September 2021).
[358] Delottie. 'The Audit Committee Report: Analysing the trends in South Africa' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/audit/za_Deloitte_The_Audit_Committee_Report_240418.pdf* (accessed on 21 September 2021).
[359] Dr. Al-Baidhani, AM 'The Nature of a Dynamic Relationship between Audit Committee and Auditors, both Internal and External' (2016) 07 *Business and Economics Journal* pg. 6.
[360] Section 94 of the Companies Act 71 or 2008.
[361] Dr. Al-Baidhani AM 'The Nature of a Dynamic Relationship between Audit Committee and Auditors, both Internal and External' (2016) 07 *Business and Economics Journal* pg. 9.
[362] Al-Mamun A, Nathan TM, Md. Rahman A. Wickramasinghe A, Yasser QR 'Relationship Between Audit Committee Characteristics, External Auditors and Economic Value Added (Eva) Of Public Listed Firms in Malaysia' (2012) 12 *Corporate Ownership & Control* pg. 900.

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‘significant role in ascertaining the validity, acceptability and reliability of financial statements’[363] of the company.

4.4.4. Oversight of Internal Auditors

One of the main resources that the audit committee has when it comes to overseeing a company is that of internal auditors, as they provide the audit committee with continued objective assessment of the state of the necessary financial records and skills of the company.[364] This relationship is also important as the audit committee becomes more reliant on the internal auditors when the company grows in size and complexity.[365] The meetings between the audit committee and the internal auditors are important as they allow for better understanding of the auditing an accounting issues that are faced by the company.[366] This also allows that if an issue does arise, the audit committee ‘can direct the proper level of internal audit function to address the problem promptly’.[367]

4.4.5. Reporting and Disclosure

The audit committee has an obligation to report and disclose all information to shareholders.[368] This is done by including the information in the annual financial statements and explaining matters such as ‘how the audit committee carried out its functions, whether the auditor was independent and commenting on the financial statements, accounting practices and internal financial control measures of the company’.[369] This is regulated by the Companies Act.[370]

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[363] Al-Mamun A, Nathan TM, Md. Rahman A. Wickramasinghe A, Yasser QR ‘Relationship Between Audit Committee Characteristics, External Auditors and Economic Value Added (Eva) Of Public Listed Firms in Malaysia’ (2012) 12 *Corporate Ownership & Control* pg. 899.
[364] Braiotta Jr L, Gazzaway RT, Colson R, Ramamoorti S *The Audit Committee Handbook* 5ed (2010) Ch 1.
[365] Braiotta Jr L, Gazzaway RT, Colson R, Ramamoorti S *The Audit Committee Handbook* 5ed (2010) Ch 1.
[366] Al-Mamun A, Nathan TM, Md. Rahman A. Wickramasinghe A, Yasser QR ‘Relationship Between Audit Committee Characteristics, External Auditors and Economic Value Added (Eva) Of Public Listed Firms in Malaysia’ (2012) 12 Corporate Ownership & Control pg. 901.
[367] Al-Mamun A, Nathan TM, Md. Rahman A. Wickramasinghe A, Yasser QR ‘Relationship Between Audit Committee Characteristics, External Auditors and Economic Value Added (Eva) Of Public Listed Firms in Malaysia’ (2012) 12 Corporate Ownership & Control pg. 901.
[368] Deloitte. ‘Audit Committee Resource Guide’ available at *https://www2.deloitte.com/za/en/pages/audit/articles/audit-committee-resource-guide.html* (accessed on 21 September 2021).
[369] Deloitte. ‘Audit Committee Resource Guide’ available at *https://www2.deloitte.com/za/en/pages/audit/articles/audit-committee-resource-guide.html* (accessed on 21 September 2021).
[370] Companies Act 71 of 2008.

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Though this information is found within the Companies Act,[371] King IV has also made comments regarding reporting and disclosure, and has stated that additional information needs to be provided within the audit committee report.[372] This includes a brief summary of the role of the audit committee within the company, an indication that the members of the audit committee have complied with the listed requirements in the Companies Act,[373] the full names and qualifications of all members of the audit committee, the number of meetings the audit committee has had and the attendance of the members to the meetings, performance evaluation results of the audit committee, and finally a statement to show that the external auditor was independent of the company and that the audit committee is satisfied with this.[374]

These are not just random duties and responsibilities imposed on the audit committee – they derive from statuary legislation and rules. It is therefore important to explore these statutory legislation and rules.

4.5. Legislation and Principles Governing the Audit Committee's Duties and Responsibilities Including Financial Literacy

I will be looking at rules and legislations that govern the financial literacy of the audit committee. This will show the importance South Africa places on the financial literacy of the audit committee.

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4.5.1. Companies Act

The Companies Act[375] is an important document when examining the governance and establishment of the audit committee, as the key role of the audit committee can be found within the Companies Act.[376] Section 94[377] governs the composition and establishment of the audit committee. It states that a public company, a state-owned company or any other company required

[371] Companies Act 71 of 2008.
[372] Institute of Directors Southern Africa 'King IV: Report on Corporate Governance for South Africa 2016' available at *https://www.adams.africa/wp-content/uploads/2016/11/King-IV-Report.pdf* (accessed on 22 September 2021).
[373] Act 71 of 2008.
[374] Deloitte. 'Audit Committee Resource Guide' available at *https://www2.deloitte.com/za/en/pages/audit/articles/audit-committee-resource-guide.html* (accessed on 21 September 2021).
[375] Act 71 of 2008.
[376] Act 71 of 2008.
[377] Section 94 of the Companies Act 71 of 2008.

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by its Memorandum of Incorporation (MOI) at their annual general meeting needs to appoint an audit committee.[378] This goes further and states that a least three directors need to be appointed for the audit committee, either at incorporation of the company or within 40 days of incorporation, by the shareholders unless 'the company is a subsidiary of another company that has an audit committee and that audit committee will perform the functions required under this section on behalf of that subsidiary'.[379] The independence of the audit committee is particularly important when appointing directors to the audit committee – shareholders need to keep in mind and understand section 94(4).[380] They may not appoint members who

- have been 'involved in the day-to-day management for the past financial year';[381]
- have been 'a full-time employee for the company for the past three financial years';[382]
- have been 'a material supplier or customer of the company such that a reasonable and informed third party would conclude in the circumstances that the integrity, impartiality or objectivity of that director is compromised by that relationship';[383]and
- who 'are related to anybody who falls within the above criteria'.[384]

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In theses cases, the result will not be a valid audit committee that meets the requirements of the Companies Act[385] and cannot function in the capacity of an audit committee; this opens up the possibility of liability for the committee members.[386] By ensuring that they do not appoint any members that fall within the above categories, they ensure the independence of the audit committee. It is important to note that these requirements do not preclude anyone who hold shares within the company from serving as a member of the audit committee. Section 94[387] further sets

[378] Section 94 of the Companies Act 71 of 2008.
[379] Section 94 of the Companies Act 71 of 2008.
[380] Section 94(4) of the Companies Act 71 of 2008.
[381] Section 94(4)(b)(i) of the Companies Act 71 of 2008.
[382] Section 94(4)(b)(ii) of the Companies Act 71 of 2008.
[383]Section 94(4)(b)(iii) of the Companies Act 71 of 2008.
[384] Section 94(4)(c) of the Companies Act 71 of 2008.
[385] Act 71 of 2008.
[386] Deloitte. 'Audit Committee Resource Guide' available at *https://www2.deloitte.com/za/en/pages/audit/articles/audit-committee-resource-guide.html* (accessed on 21 September 2021).
[387] Section 94 of the Companies Act 71 of 2008.

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out the duties (s94(7))[388] and responsibilities of the audit committee. This includes section 94(6),[389] which states that if there is a vacancy on the audit committee, it must be filled within 40 days after the vacancy arises.[390] As previously mentioned, enhanced accountability and transparency are important when it comes to the appointment of the audit committee, and this is regulated by Chapter 3 of the Companies Act.[391]

Another important subsection is section 94(5).[392] This deals with the qualifications of the audit committee. It states that the Minster may add additional requirements to than those that are prescribed by the Companies Act[393] to the audit committee to ensure that they have the relevant knowledge, skills and experience to be able to perform their functions to their best abilities.[394] Currently, the qualifications and experiences that are set out by the Minster allows for a wide range, including 'academic qualifications or experience in economics, law, corporate governance, finance, accounting, commerce, industry, public affairs or human resource management'.[395] These requirements must be met by members of the audit committee.

4.5.2. Common Law

When it comes to the audit committee members and their governance, both executive and non-executive members are considered to be part of the board of directors; even though they serve on the audit committee, they carry the same position with added duties that the other directors owe toward the company.[396] Though the common law does not require any specific skills from the audit committee, the common law expects that directors need to act within the best interests of the company and in good faith, with the proper care, skill and diligence, in order to ensure the success of the company.[397] This can also be seen under section 76 of the Companies Act.[398] As members

[388] Section 94(7) of the Companies Act 71 of 2008.
[389] Section 94(6) of the Companies Act 71 of 2008.
[390] Section 94(6) of the Companies Act 71 of 2008.
[391] Act 71 of 2008.
[392] Section 94(5) Companies Act 71 of 2008.
[393] Act 71 of 2008.
[394] S94(5) Companies Act 71 of 2008.
[395] KPMG 'The Audit Committee Toolkit' available at *http://www.acf.co.za/wp-content/uploads/2015/06/2015-ACF-Toolkit.pdf* (accessed on 21 September 2021).
[396] Razak AA, Sor ZM, Mohamad S 'Audit Committees: From the Legal Perspective' (2004) *SSRN Electronic Journal.*
[397] Morulane M 'Understanding the Fundamental Duties and Responsibilities of a Director of a Company' available at *https://serr.co.za/understanding-the-fundamental-duties-and-responsibilities-of-a-director-of-a-company* (accessed on 23 September 2021).
[398] Section 76 of the Companies Act 71 of 2008.

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of the audit committee are also directors, these principles can therefore be expected by the audit committee as well, including ensuring that they have the proper financial literacy to do their duties towards the company independently and without putting the company in harm's way.

4.5.3. Memorandum of Incorporation

The MOI, as the governing (constitutional document) of a company, plays a role when it comes to the appointment of an audit committee at a company, as it becomes binding to the audit committee, as it does with the board of directors. There are certain categories of companies (public companies and state-owned companies) that are required by the Companies Act to appoint an audit committee.[399] Other companies that do not fall within these categories, such as a private company, personal liability company or non-profit company, need to make provision within their MOI for the appointment of an audit committee, provided that they still meet the requirements that are provided for within the Companies Act.[400]

4.5.4. Johannesburg Stock Exchange

As mentioned in the previous chapter, the JSE Listing Requirements work in conjunction with the Companies Act; therefore when dealing with the composition of the audit committee under the JSE, companies need to make sure their appointments are in line with the Companies Act[401] as well as take into consider consideration King IV.[402] As within the Companies Act,[403] the independence of the audit committee is vital; therefore appointing directors to the audit committee needs to be done 'holistically on a substance over form basis in accordance with the indicators

[399] Deloitte. 'Appointment of the audit committee and independence requirements' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_AppointmentOfTheAuditCommitteeAndIndependenceRequirements_24032014.pdf* (accessed on 21 September 2021).
[400] Deloitte. 'Appointment of the audit committee and independence requirements' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_AppointmentOfTheAuditCommitteeAndIndependenceRequirements_24032014.pdf* (accessed on 21 September 2021).
[401] Act 71 of 2008
[402] Act 71 of 2008.
[403] Act 71 of 2008.

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provided in section 94(4) of the Companies Act[404] and the King Code IV'.[405] Yet unlike the Companies Act,[406] which states if a person has shares in the company they can still be considered to be on the audit committee, the JSE has taken a different stance by stating that 'any director that participates in a share incentive/option scheme, will not be regarded as independent'[407] and thus cannot be part of the audit committee.

Though section 94(7)[408] provides for duties that need to be carried by the audit committee, the JSE Listing Requirements has added additional expectations to what is required from the audit committee, including:

- the audit committee needs to ensure that there is a financial reporting procedure that is appropriate to the needs of the company and that it is operating effectively;[409]
- when an audit firm is appointed, the audit committee needs to ensure that they have all relevant information and request all relevant information regarding the auditors and whether they are qualified for the position;[410] and
- where an individual auditor is selected, the audit committee needs to ensure that the individual does not appear on the JSE list of disqualified individual auditors.[411]

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When it comes to the financial literacy of audit committee members under the JSE Listing Requirements, which works in conjunction with the Companies Act, section 94(5)[412] becomes relevant to any company that is registered under the Companies Act.[413] This means that audit

[404] Section 94(4) of the Companies Act 71 of 2008.
[405] Deloitte. 'Audit Committee Resource Guide' available at *https://www2.deloitte.com/za/en/pages/audit/articles/audit-committee-resource-guide.html* (accessed on 21 September 2021).
[406] Act 71 of 2008.
[407] Deloitte. 'Audit Committee Resource Guide' available at *https://www2.deloitte.com/za/en/pages/audit/articles/audit-committee-resource-guide.html* (accessed on 21 September 2021).
[408] Section 94(7) of the Companies Act 71 of 2008.
[409] LexisNexis: JSE Limited Listings Requirements.
[410] LexisNexis: JSE Limited Listings Requirements.
[411] LexisNexis: JSE Limited Listings Requirements.
[412] Section 94(5) of the Companies Act 71 of 2008.
[413] Act 71 of 2008.

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committee members need to have the proper skills, knowledge and experience to be appointed to the audit committee, as prescribed by the Minister.

4.5.5. King Code IV

King IV emphasises the vital role that the audit committee has within the company, and places emphasis on its important role when it comes to the reporting of financial statements, its relationship with internal and external auditors and the service that it provides to the board of directors.[414] King IV defines two major roles that the audit committee provides for the company, namely effective company assurance functions and services, and keeping the integrity of the financial statements, while keeping independent oversight.[415] Previously in King III, there were recommendations made that every company needs to have an audit committee to assist the board with the financial factors of the company, yet in King IV this position has changed and now leaves it in the hands of the board of directors to decide whether or not the company should appoint an audit committee, following the legal requirements laid out in the Companies Act.[416]

As with the Companies Act, MOI and JSE Listing Requirements, King IV echoes and emphasises the importance of the independence of the audit committee, stating that when appointing shareholders to the audit committee careful consideration needs to be given to the best practice principles set out in the King IV: appointments need to be in line with these principles.[417] Compared to King III, the concept of independence of the members in audit committee in King IV has developed significantly.[418] King III presented a list that disqualifies a member who is seen as

[414] Institute of Directors Southern Africa (2016) King IV: Report on Corporate Governance for South Africa 2016 available at *https://www.adams.africa/wp-content/uploads/2016/11/King-IV-Report.pdf* (accessed on 22 September 2021).
[415] du Plessis P, Natesan P (2019) Institute of Directors South Africa: Audit committees: A healthy environment of challenge available at *https://www.iodsa.co.za/news/475956/Audit-committees-A-healthy-environment-of-challenge-.htm* (accessed 21 September 2021).
[416] Crous, C (2017) The 1-2-3 of Audit Committees: Part 1: Overview of The Recommendation available at *https://www.saica.co.za/portals/0/documents/123_OF_AUDIT_COMMITTEES.pdf (*accessed on 22 September 2021).
[417] Institute of Directors Southern Africa (2016) King IV: Report on Corporate Governance for South Africa 2016 available at *https://www.adams.africa/wp-content/uploads/2016/11/King-IV-Report.pdf* (accessed on 22 September 2021).
[418] Institute of Directors Southern Africa ‘King IV: Report on Corporate Governance for South Africa 2016’ available at *https://www.adams.africa/wp-content/uploads/2016/11/King-IV-Report.pdf* (accessed on 22 September 2021).

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non-independent.[419] This changed within King IV, as now a board of directors should 'always consider the independence of a director from the perspective of a reasonable and informed third party';[420] therefore even if a person had to meet more than one of the requirements that disqualify them under King III, under King IV they would not automatically be seen as non-independent.[421]

Under Practice 55 of King IV, mention is made of the importance of the financial literacy of the audit committee.[422] It mentions that members of the audit committee needs to have the necessary skill, financial literacy and experience as a whole to be able to complete their duties toward the company.[423] Before setting up the audit committee, it should be laid out what skills are needed by the members before they are selected, such as an 'understanding of internal financial controls, external audit process, internal audit process, corporate law, risk management, governance of information',[424] financial reporting and accounting issue, just to mention a few. Furthermore, King IV recommends that all the members of the audit committee's names, qualifications and experience needs to be disclosed to the board of directors.[425]

I now explore the importance of holding audit committee members accountable for their actions.

4.6. <u>Audit Committee Members' Accountability</u>

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[419] Deloitte. 'Audit Committee Resource Guide' available at *https://www2.deloitte.com/za/en/pages/audit/articles/audit-committee-resource-guide.html* (accessed on 21 September 2021).
[420] Deloitte. 'Audit Committee Resource Guide' available at *https://www2.deloitte.com/za/en/pages/audit/articles/audit-committee-resource-guide.html* (accessed on 21 September 2021).
[421] Institute of Directors Southern Africa 'King IV: Report on Corporate Governance for South Africa 2016' available at *https://www.adams.africa/wp-content/uploads/2016/11/King-IV-Report.pdf* (accessed on 22 September 2021).
[422] Institute of Directors Southern Africa 'King IV: Report on Corporate Governance for South Africa 2016' available at *https://www.adams.africa/wp-content/uploads/2016/11/King-IV-Report.pdf* (accessed on 22 September 2021).
[423] Institute of Directors Southern Africa 'King IV: Report on Corporate Governance for South Africa 2016' available at *https://www.adams.africa/wp-content/uploads/2016/11/King-IV-Report.pdf* (accessed on 22 September 2021).
[424] Deloitte. 'Audit Committee Resource Guide' available at *https://www2.deloitte.com/za/en/pages/audit/articles/audit-committee-resource-guide.html* (accessed on 21 September 2021).
[425] Deloitte. 'Audit Committee Resource Guide' available at *https://www2.deloitte.com/za/en/pages/audit/articles/audit-committee-resource-guide.html* (accessed on 21 September 2021).

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The activities of the audit committee includes working alongside the board of directors, managing and reporting financial statements, and working with the internal and external auditors. I will now consider why the audit committee needs to be held accountable for its actions.

Being part of the audit committee is a duty that should not be taken lightly – members of the audit committee should perform their duties responsibly since, as with directors, the Companies Act[426] extends personal liability to the audit committee for losses due to their negligence or non-compliance with the provisions of the Companies Act.[427] As the audit committee is made up of independent directors, it needs to take the proper care, skill and diligence when conducting its duties within the audit committee. Audit committee members are responsible for ensuring that risk and fraud are monitored and reported. This includes:

- financial statement fraud;[428]
- asset misappropriation, such as forgery, theft of money or payroll fraud; and[429]
- corruption/kickbacks/shell companies/bribes to influence decision-makers.[430]

The question then arises: What if it is the audit committee that is committing these acts? Every member of the audit committee needs to understand their role and accept responsibility for any misconduct that happens during the carrying out of their duties.[431] Various authors have also stated the possibility of audit committees having a high liability to that of directors.[432] Another writer stated that it is normal that when there is an increase in the responsibility, there is an increase of

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[426] Act 71 of 2008.
[427] RSM 'The duties and responsibilities of an audit committee' available at *https://www.rsm.global/southafrica/news/duties-and-responsibilities-audit-committee* (accessed on 23 September 2021).
[428] Deloitte. 'Audit Committee Resource Guide' available at *https://www2.deloitte.com/za/en/pages/audit/articles/audit-committee-resource-guide.html* (accessed on 21 September 2021).
[429] Deloitte. 'Audit Committee Resource Guide' available at *https://www2.deloitte.com/za/en/pages/audit/articles/audit-committee-resource-guide.html* (accessed on 21 September 2021).
[430] Deloitte. 'Audit Committee Resource Guide' available at *https://www2.deloitte.com/za/en/pages/audit/articles/audit-committee-resource-guide.html* (accessed on 21 September 2021).
[431] Marx B. *An Analysis of the Development, Status and Function of Audit Committee at Largest Listed Companies in South Africa* (unpublished Doctorate Commercii thesis, University of Johannesburg, 2008) pg. 13.
[432] Deloitte. 'The Role of the Audit Committee available at *https://www2.deloitte.com/content/dam/Deloitte/us/Documents/center-for-board-effectiveness/us-audit-committee-resource-guide-section-2.pdf* (accessed on 16 September 2021).

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liability – as the audit committee members have been handed more responsibility by both legislation and the MOI, this automatically means there is increased liability.[433]

Though there is no case law in South Africa where action was taken against the audit committee specifically, many international cases show how audit committees are dealt with. This can be used as a guide for how South Africa should deal with audit committee members who commit financial misconduct.

4.6.1. Audit Committee Members' Financial Literacy relationship with Corporate Governance and Business Ethics

I have previously explained corporate governance and business ethics and their importance within the corporate world. For corporate governance and business ethics to be effective, all the role-players need to play an active role and work collaboratively with each other to ensure its success, including the audit committee, the board of directors, internal and external auditors, and general management.[434]

Briefly, corporate governance is defined as a company's purposes and the way it is run; this includes all aspects such as its organization, communication, leadership and strategic decision-making.[435] When it comes to the audit committee and corporate governance, they play a key role for direction, control, accountability, and reduction of potential fraudulent financial activity.[436] 'The audit committee's composition, competence, independence, and expertise are strongly correlated with the organization's corporate governance'.[437] This is done by the audit committee's assisting the board of directors with advice and recommendations regarding matters such as

[433] RSM 'The duties and responsibilities of an audit committee' available at *https://www.rsm.global/southafrica/news/duties-and-responsibilities-audit-committee* (accessed on 23 September 2021).
[434] KPMG 'The Audit Committee's Oversight Role on Financial Reporting 2013' available at *https://assets.kpmg/content/dam/kpmg/pdf/2016/03/20140701_aci-oversight-2013.pdf* (accessed on 15 September 2021).
[435] Price N 'Importance of Corporate Governance in an Organization' available at *https://insights.diligent.com/corporate-governance/importance-of-corporate-governance-in-an-organization* (accessed on 20 November 2020).
[436] Dr. Al-Baidhani AM 'The Role of Audit Committee in Corporate Governance: A Descriptive Study' (2016) 2 *International Journal of Research & Methodology in Social Science* pg. 6.
[437] Dr. Al-Baidhani AM 'The Role of Audit Committee in Corporate Governance: A Descriptive Study' (2016) 2 *International Journal of Research & Methodology in Social Science* pg. 11.

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management, internal and external auditors, assisting with financial statements by ensuring that they have been prepared accurately, as well as ensuring that any compensation that is owed to the board of directors is paid to them fairly.[438] This all helps in making sure that the company has good corporate governance. As the board of directors is the main party responsible for good corporate governance, the audit committee's supporting role to the board makes it a similarly key role-player in corporate governance.[439] This is done principally by submitting the audit committee report.[440]

The audit committee also plays a vital role in business ethics by fulfilling its oversight responsibility 'regarding the company's ethical compliance and the fostering of a culture of doing business ethically'.[441] All the members of the company, including the board of directors, executive management and employees have the responsibility to act ethically; with that being said, the audit committee is placed on a fairly different scale as it can be seen as the conscience of the board of directors as it 'takes oversight responsibility for business ethics'.[442]

Since one of the mains responsibilities of the audit committee concerns financial accuracy, when its members lack the appropriate qualifications and financial literacy to be able to perform these responsibilities, this can have a negative impact on corporate governance and business ethics. They will not be able to carry out their duties correctly, and this can lead to personal liability claims against members of the audit committee.

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4.6.2. Audit Committee Members' Accountability for Lack of Financial Literacy in South Africa and Protection Provided by South African Legislation

Previously I explored the governing principles and legislation applicable to a board of directors, focusing on those that have ramifications for directors who do not have the necessary financial literacy and who commit financial misconduct. This can similarly apply to the audit committee, as

[438] Dr. Al-Baidhani AM 'The Role of Audit Committee in Corporate Governance: A Descriptive Study' (2016) 2 *International Journal of Research & Methodology in Social Science* pg. 15.
[439] Dzomira S 'Corporate Governance and Performance of Audit Committee and Internal Audit Functions in an Emerging Economy's Public Sector' (2020) 13 *Indian Journal of Corporate Governance* pg. 89.
[440] Dr. Al-Baidhani AM 'The Role of Audit Committee in Corporate Governance: A Descriptive Study' (2016) 2 *International Journal of Research & Methodology in Social Science* pg. 6.
[441] Marx B, Els G 'The role of the audit committee in strengthening business ethics and protecting stakeholders' interests' (2014) 4 *African Journal of Business Ethics* pg. 7.
[442] Marx B, Els G 'The role of the audit committee in strengthening business ethics and protecting stakeholders' interests' (2014) 4 *African Journal of Business Ethics* pg. 8.

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members of the audit committee are still seen as directors and therefore carry much the same duties and responsibilities. This was confirmed in *Philips v Fieldstone Africa (Pty) Ltd*,[443] where the Supreme Court of Appeal held that 'the standard of conduct expected of a director extends to anyone who occupies a position of trust in relationship to the company'.[444]

Acting ethically, honestly and with integrity is one of the key attributes that the board of directors and executive management including the audit committee need to have so as to set an example for their employees.[445] Since the audit committee is in charge of the investigation of alleged fraud and financial misconduct within the company, it is important that they are also held responsible for misconduct, particularly financial misconduct that they commit.[446] Under the section 76(3)(c)[447] (standards of directors' conduct), which is applicable to any members of the audit committee, it states that audit committee members need to have 'general knowledge, skill and experience'.[448] Not having the proper experience and skill can therefore open the door for criminal and civil liability.[449] Another applicable section is section 77,[450] which concerns the liability of directors and prescribed officers. Similar with many sections within the Companies Act[451] that are applicable to the board of directors, section 77[452] is applicable not only to the board but to 'any director, an alternate director, a prescribed officer (as designated by the Minister), a person who is a member of a committee of a board of a company, or a member of the audit committee of a company irrespective of whether or not the person is also a member of the company's board'.[453] The audit committee can be both jointly and severally liable if members do not perform their duties

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443 [2004] 2 All SA 150.
444 Cox I 'South Africa: The Standard Of Directors Conduct – Unpacking Section 76 Of The Companies Act 71 of 2008' available at *https://www.mondaq.com/southafrica/directors-and-officers/214918/the-standard-of-directors-conduct--unpacking-section-76-of-the-companies-act-71-of-2008* (accessed on 8 December 2021).
445 Marx B, Els G 'The role of the audit committee in strengthening business ethics and protecting stakeholders' interests' (2014) 4 *African Journal of Business Ethics* pg. 7.
446 Burke FM, Guy DM, Tatum KW *Audit Committees: A Guide for Directors, Management, and Consultants* 5ed (2008) pg. 22.
447 Section 76(3)(c) of the Companies Act 71 of 2008.
448 Section 76(3)(c) of the Companies Act 71 of 2008.
449 Institute of Directors South Africa 'Director Misconduct: General guidance note on how to approach director misconduct' available at *https://cdn.ymaws.com/www.iodsa.co.za/resource/collection/49D62EF3-F749-403C-BE47-73C50F27F30F/IoDSA_Guidance_for_Boards_-_Director_Misconduct.pdf* (accessed on 4 August 2021).
450 Section 77 of the Companies Act 71 of 2008.
451 Act 71 of 2008.
452 Section 77 of the Companies Act 71 of 2008.
453 Section 77 of the Companies Act 71 of 2008.

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in the best interests of the company. Another section that is applicable when it comes to financial literacy of the audit committee is section 214,[454] which allows for criminal liability if an act of fraud has been perpetrated by any person in relation to a company.[455] Section 94(5),[456] which states that the Minister may prescribe minimum qualifications for those who want to be members of the audit committee, must be followed – if it is not, those members will be in direct breach of the Companies Act.[457]

Now that I have explored the possible repercussion of the audit committee members not having financial literacy in South Africa, I will now explore the importance that other countries place on the audit committee's financial literacy.

4.7. Role of the Audit Committee Members in Different Countries and Financial Literacy Implementation

I explored the role of the audit committee in South Africa, and the rules and legislation that governs it. To better explore how these can be improved to ensure that South Africa provides better protection to its companies, I will be exploring foreign law to showcase the importance that they place on ensuring that the audit committee has the proper financial literacy. The countries under review are Australia, the United States, and Malaysia.

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4.7.1. Australia

Australia has suffered company scandals, which has resulted in its needing to ensure that investors are confident in investing in both domestic and international companies.[458] This is done through the promotion of good corporate governance and business ethics and by continuing to 'reflect local and international developments and promote high standards of transparency about the corporate

[454] Section 214 of the Companies Act 71 of 2008.
[455] Section 214 of the Companies Act 71 of 2008.
[456] Section 94(5) of the Companies Act 71 of 2008.
[457] Act 71 of 2008.
[458] ASIC 'Audit quality -The role of directors and audit committees' available at *https://asic.gov.au/regulatory-resources/financial-reporting-and-audit/auditors/audit-quality-the-role-of-directors-and-audit-committees/* (accessed on 7 October 2021).

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governance practices of listed entities'.[459] It is also achieved through the governance and practices of the audit committee.

The audit committee in Australia plays an important role within the corporate field, particularly when it comes to financial reporting.[460] The ASX Listing Rules state that companies listed under the S&P All Ordinaries Index (the 500 largest entities by market capitalisation) must have an audit committee at the start of the financial year.[461] It is a similar structure to the audit committee S=in South Africa. The scope of its work is broad and includes corporate governance, financial management, policies, annual reporting and financial statements, fraud and corruption control, ethics and organisations culture, internal and external auditors, legal issues and major projects and business initiatives.[462] These functions of the audit committee are further laid out under section 17 of the Public Governance, Performance and Accountability Rule 14.

The requirements for the establishment of the audit committee in Australia are that there should be at least be 'three members, [and that] all the members should be non-executive directors and finally that the majority of the members should also be independent directors'.[463] When it comes to holding audit committee members accountable, they are seen as having duties and qualifications equal to that of directors and therefore are held accountable to the same standards as directors.[464] As within the Centro case discussed in chapter 3, the court held that where directors commit misconduct, they can be held personally liable for it.[465] Applying this to the audit committee, the

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[459] OECD 'Principles of Corporate Governance' available at *https://www.oecd.org/daf/ca/Corporate-Governance-Principles-ENG.pdf* (accessed on 8 October 2021).
[460]Audit Committee Guide 'How can audit committee members add value?' available at *https://www.pwc.com.au/assurance/assets/audit-committee-guide/ac-guide-booklet-dec11.pdf* (accessed on 7 October 2021).
[461] ASIC 'Audit quality -The role of directors and audit committees' available at *https://asic.gov.au/regulatory-resources/financial-reporting-and-audit/auditors/audit-quality-the-role-of-directors-and-audit-committees/* (accessed on 7 October 2021).
[462] The Institute of Internal Auditors Australia 'Audit Committees' available at *https://iia.org.au/sf_docs/default-source/technical-resources/2018-fact-sheets/audit-commitees808E8F847AE0.pdf?sfvrsn=10* (accessed on 7 October 2021).
[463]Australian Institute of Company Directors 'Role of the Audit Committee' available at *https://aicd.companydirectors.com.au/resources/all-sectors/roles-duties-and-responsibilities/role-of-the-audit-committee?no_redirect=true* (accessed on 8 October 2021).
[464] Deloitte. 'The Companies Act Australian 'Centro-case' confirms duties of all directors' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_CentroCaseConfirmsDirectorDuties_24032014.pdf* (accessed on 7 October 2021).
[465] Deloitte. 'The Companies Act Australian 'Centro-case' confirms duties of all directors' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_CentroCaseConfirmsDirectorDuties_24032014.pdf* (accessed on 7 October 2021).

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audit committee needs to ensure that it applies proper skill, care and diligence when conducting its duties and responsibilities to ensure that members are not held personally liable for any misconduct.[466]

4.7.2. United States of America

The audit committee is an important role-player in the United States. The Sarbanes-Oxley Act[467] requires that the Securities and Exchange Commission (SEC) sets rules in relation to audit committees.[468]

It is expected that all the members of the audit committee should have a mix of the appropriate skills, experience and expertise, though it is expected that at least one member of the audit committee under section 407 of the Sarbanes-Oxley Act[469] needs to be a financial expert. Such a understands what 'GAAP and financial reporting is and is able to assess the handling for accounting estimates and reserves, has experience with financial reporting and internal accounting controls, and understands audit committee functions'.[470] If a company does not have one member on the audit committee that is considered to be a financial expert, it needs to explain why it does not. The name of the financial expert also needs to be disclosed; if there is more than one financial expert within the audit committee, only the name of the main expert needs to be disclosed.[471]

The New York Stock Exchange Requirements (NYSE) also makes provision for the financial literacy of the audit committee. It states that all members of the audit committee need to have financial literacy, with the level or understanding of the term 'financial literate' determined by the

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[466] Deloitte. 'The Companies Act Australian 'Centro-case' confirms duties of all directors' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_CentroCaseConfirmsDirectorDuties_24032014.pdf* (accessed on 7 October 2021).
[467] Act of 2002.
[468] Audit Committee Guide 'How can audit committee members add value?' available at *https://www.pwc.com.au/assurance/assets/audit-committee-guide/ac-guide-booklet-dec11.pdf* (accessed on 7 October 2021).
[469] Section 407 of the Sarbanes-Oxley Act 2002.
[470] Protiviti 'The Audit Committee Requirements' available at *https://www.protiviti.com/US-en/insights/bulletinv1-i9* (accessed on 7 October 2021).
[471]Deloitte. 'The Companies Act Australian 'Centro-case' confirms duties of all directors' available at *https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_CentroCaseConfirmsDirectorDuties_24032014.pdf* (accessed on 7 October 2021).

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board of directors.[472] The NYSE also makes the provision that at least one member of the audit committee needs to have expertise when it comes to accounting or related financial management; once again that is determined by the board of directors.[473]

Another multinational financial service corporation that makes provisions for the financial literacy of the audit committee is the National Association of Securities Dealers Automated Quotations (NASDAQ), which owns and operates three stock exchanges in the United States. It states in its listing standards that during their appointment to the audit committee all members need to be able to read and understand financial statements at all times.[474] NASDAQ similarly to that of the NYSE and the SEC require that at least one member in this case has to be financially literate. This mean that through 'employment experience in finance or accounting, professional certification in accounting, or any comparable experience'[475] he or she has gained financial sophistication. Companies and audit committees that do not comply with the regulations above will face the consequences of fines or imprisonment, or both.[476]

4.7.3. <u>Malaysia</u>

Another country that has made provisions for the financial literacy of the audit committee is Malaysia. In the Bursa Securities Listing Requirements, paragraph 15.09(1)(c)[477] highlights the importance that is placed on the audit committee within the company, particularly its financial responsibility within the company, by stating that at least one member of the audit committee needs to 'be a member of the Malaysian Institute of Accountants, or if he/she is not a member then have

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[472] Colonial Stock Transfer 'NYSE Listing Requirements' available at *https://www.colonialstock.com/nyse-listings.htm* (accessed on 7 October 2021).
[473] Colonial Stock Transfer 'NYSE Listing Requirements' available at *https://www.colonialstock.com/nyse-listings.htm* (accessed on 7 October 2021).
[474]Deloitte. 'Audit committee requirements and governance topics' available at *https://www2.deloitte.com/content/dam/Deloitte/us/Documents/center-for-board-effectiveness/us-audit-committee-resource-guide-section-1.pdf* (accessed on 7 October 2021).
[475]Deloitte. 'Audit committee requirements and governance topics' available at *https://www2.deloitte.com/content/dam/Deloitte/us/Documents/center-for-board-effectiveness/us-audit-committee-resource-guide-section-1.pdf* (accessed on 7 October 2021).
[476] De Groot J 'What is SOX Compliance? 2019 SOX Requirements & More' available at *https://digitalguardian.com/blog/what-sox-compliance* (accessed on 23 November 2021).
[477]Bursa Securities Listing Requirements 'Corporate Governance' available at *https://www.bursamalaysia.com/sites/5bb54be15f36ca0af339077a/content_entry5ce3b50239fba2627b2864be/5ce3b5ce5b711a163beae1bd/files/MAIN_Chap15__Anti-corruption_1June2020.pdf?1590748016* (accessed on 7 October 2021).

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at least have 3 years' working experience and passed the examinations specified in Part I of the First Schedule of the Accountants Act 1967; or be a member of one of the associations of accountants specified in Part II of the First Schedule of the Accountants Act 1967; or he/she need to fulfil such other requirements as prescribed or approved by the Exchange'.[478]

In many of the countries that place emphasis on one member being a financial expert or having financial sophistication, financial literacy is a prerequisite for all members of the audit committee.[479] Placing the burden of special knowledge or skills in accounting on one member would allow for undue reliance and therefore render the whole purpose of the audit committee ineffective.[480]

4.8. Chapter Conclusion

In this chapter, I explained the important role that the audit committee plays within a company and then explored the governing principles that ensure the duties and responsibilities of the audit committee; this extended to the relationship that it has with the board of directors. I also examined how different countries govern their audit committees, with reference to how they ensure the financial literacy of their audit committees, as well as the penalties they set for those who commit financial misconduct.

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The audit committee's role is not limited to assisting companies with their financial reporting but more importantly it helps them attain good corporate governance and business ethics. It is very clear how important it is that the committee be financially literate so as it be able to perform its duties with proper skill, care and diligence and to the benefit of the company. The board of directors relies on the advice of the audit committee in relation to not only the financial side but the management and direction of the company. The audit committee thus needs to be well versed

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[478]Bursa Securities Listing Requirements 'Corporate Governance' available at *https://www.bursamalaysia.com/sites/5bb54be15f36ca0af339077a/content_entry5ce3b50239fba2627b2864be/5ce3b5ce5b711a163beae1bd/files/MAIN_Chap15__Anti-corruption_1June2020.pdf?1590748016* (accessed on 7 October 2021).
[479] Guidance on Effective Audit and Risk Management 'Financial literacy of audit committee members' available at *https://bursa-malaysia.s3.amazonaws.com/reports/Pullout-II-8-Practice-8-5.pdf* (accessed on 7 October 2021).
[480] Guidance on Effective Audit and Risk Management 'Financial literacy of audit committee members' available at *https://bursa-malaysia.s3.amazonaws.com/reports/Pullout-II-8-Practice-8-5.pdf* (accessed on 7 October 2021).

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in its role and understanding of the ins and outs of the company. It plays just as important a role as does the board of directors in promoting good corporate governance and business ethics.

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5. Chapter 5: Conclusion and Recommendations

5.1. Conclusion

The main purpose of this thesis was to determine whether the promotion of financial literacy in the board of directors and the audit committee members would combat financial misconduct within companies and promote better corporate governance and business ethics. In order to do this, I needed to focus on certain factors that would help lay the basis to be able to answer the question that was posed.

The first was history of financial misconduct; in South Africa, there have been many prime examples such as the eThekwini Municipality, the firing of CEO of the Airports Company SA (Acsa) or mostly famously the Steinhoff case. I placed emphasis on financial misconduct within South Africa to show that better accountability needs to be held against the board of directors and the audit committee, who are the two main groups who focus on the financial reporting and statements of the company, with this being a way to combat misconduct. In Chapter 2, I explored the concepts of corporate governance and business ethics on an international scale and regard to their relevance with the context of South Africa. In terms of corporate governance, I examined the important role they play within the growth of companies, such as ensuring that a balance of power between the main role-players (board of directors, shareholders and stakeholders) and transparency and accountability. Key legislation, rules and regulations were explored to help establish the importance that South Africa places on both corporate governance and business ethics.

Expanding on the concept of financial misconduct was important with reference to how it affects companies. As my thesis is about combatting financial misconduct, this was an important term to establish. The Public Finance Management Act[481] tries to combat this type of misconduct, yet it falls short in doing so. This thus helped me lay the basis of the importance to explore other ways to ensure more particular ensuing the financial literacy of the board of directors and audit committee member as a better way to combat financial misconduct.

Once I was able to lay the basis by understanding corporate governance, business ethics, financial misconduct and financial literacy, within chapter 3 I was able to explain the role of the board of

[481] Act 1 of 1999.

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director and their importance in ensuring good corporate governance and business ethics within the company. When going into this chapter I noted that directors do not have requirements when being appointed, only the requirements of who is disqualified as directors. This then left the MOI of the company to decide who they want to appoint as directors. It therefore important for me to the whole understanding of the board of directors so that I could make the recommendation of the importance of having requirements for the board of directors codified within the Companies Act.[482][483] The board of directors is made up of a panel of people who are essential for the running of a company and ensuring the success of the company by establishing corporate values and effective governance structures for the company. In order to highlight the important role of the board, I explored the different types of directors such as executive, non-executive and independent non-executive directors. This served to show the important role that each type of director plays within the functioning of the company. Next, the important duties and roles of the board of directors was looked at, such as establishing a company's mission and purpose, company planning, monitoring and managing financial resources, serve on committees and risk management. I then furthered looked at the governing legislation and principles (Companies Act,[484] MOI, King Code IV, Common Law and the JSE) that help ensure that the board of directors comply with what is expect of them and that if they do commit any misconduct how they were dealt with. I also focused on principles and legislation that dealt with ensuring the financial literacy of the board of directors and what type of standard of literacy they needed to comply with.

Governing legislation and principles that were explored though slightly different all expressed the importance of the board of directors within financial reporting and presenting financial statements. This clearly showed that the board of directors having basic understanding of financial literacy is a fiduciary duty that can be applied on directors, as those directors who are financially literate are able to understand the company's financial performance better and thus make decisions that are in good faith and in the best interest of the company's future development.[485] It should be important to note all members on the board of directors need not be financial experts, but the members of the board should at least be expected to have basic financial literacy including being able to read and

[482] Act 71 of 2008.
[483] Act 71 of 2008.
[484] Act 71 of 2008.
[485] Professor Cossin D, Hongze Lu A, IMB 'A note on Finance Essentials for Directors' available at *https://www.imd.org/research-knowledge/articles/a-note-on-finance-essentials-for-directors/* (accessed on 8 December 2021).

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evaluate financial statements, basic terminology, and know the financial position of the company. I also highlighted that though the audit committee assist the board of directors with the financial statement and reporting they should not be expected to have the same financial literacy as the audit committee. Yet they should also not blindly rely on what the audit committee presents before them regarding the financial standing as the company so that they are able to avoid things such as sales manipulation, expense manipulation and incorrect assets evaluation, as noted in be seen in *Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd.*[486] I also explored the principle of the business judgment rule and found that the rule does not protect directors who did not to take reasonable steps to be informed about the matter in front of them, which would include the financial statements.[487]

Finally, looking at the role of the board of directors in different countries (Australia and United States of America) and the implementation of financial literacy showed the importance of codifying that directors need to have financial literacy to perform their duties. A director should be held liable for not having basic financial literacy when dealing with financial statements as it is a key part of his or her duties and responsibilities. Taking on the role of director, one takes on the duties that come with that.

Next, I focused on another important group when it comes to the financial reporting and statements of a company and who work closely with the board of directors, that is the audit committee, by exploring the role of the audit committee in the governance of a company, the company's direction, control and accountability. I then explored the composition of the audit committee with reference to the King Code IV and the Companies Act,[488] and touched on the importance of following the statutory requirements for a recognised audit committee. Similarly, as in the previous chapter when looking at the board of directors and the type of directors, I explored the different types of auditors, their roles within the company and particularly their relationship with the audit committee. In order to ascertain the importance of why both the board of directors and audit committee need to have financial literacy, I explored the relationship between the two groups. While carrying out their duties, the audit committee report to the board of directors, particularly when it comes to the financial side of the company. In some cases, the board relies strongly on the findings of the audit

[486] 1980 (4) SA 156 (W).
[487] Wiese T 'Corporate Governance in South Africa with International Comparisons' (2014) pg. 138.
[488] Act 71 of 2008.

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committee, though this is frowned upon that the board should just blindly accept what the audit committee places in front of the directors. By discussing the duties and responsibilities of the audit committee such as oversight of financial reporting and internal controls, risk oversight, interaction with the external auditor and reporting and disclosure to name some, I was able to assess the importance of the audit committee's having financial literacy to be able to perform its duties and responsibilities. The Companies Act,[489] Common Law, King Code IV, the JSE and a company's MOI all make provisions for the audit committee and all express how important they are for the functioning of the company and express the importance of them performing their duties in the best interest of the company. Discussing the accountability that audit committee members face when not performing their duties and how this relates to the audit committee promoting good corporate governance and business ethics, showed the importance of audit committee members needing to understand financial statements and reporting. As with directors liabilities, audit committees face the same consequences as in *Philips v Fieldstone Africa (Pty) Ltd*,[490] where the Supreme Court of Appeal confirmed that 'the standard of conduct expected of a director extends to anyone who occupies a position of trust in relationship to the company'.[491] Reviewing the different manners in which various countries (Australia, the United States and Malaysia) govern the role of the audit committee was important.

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5.2. Recommendations

Now that I have recapped the aspects that I discussed within the thesis, it is important that I round up the major point to be able to answer the question as to how ensuing financial literacy of the board of directors and audit committee can combat financial misconduct. It is my opinion, looking at all the information that was presented, that the board of directors plays a very significant role within a company; particularly in financial reporting to the shareholders, they need to act with the proper care, skill and diligence and need to take all necessary steps to do so. Financial misconduct seems to occur mainly in upper management from the cases that I explored, so those responsible for ensuring that no error occurs need to have the proper skills to do so. Ensuring that directors are held liable, companies need to also make sure that directors know what is expected of them. Merely

[489] Act 71 of 2008.
[490] [2004] 2 All SA 150.
[491] Cox I 'South Africa: The Standard Of Directors Conduct – Unpacking Section 76 Of The Companies Act 71 of 2008' available at *https://www.mondaq.com/southafrica/directors-and-officers/214918/the-standard-of-directors-conduct--unpacking-section-76-of-the-companies-act-71-of-2008* (accessed on 8 December 2021).

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relying on a few directors on the board to ensure that they can make sure that financial reporting is correct, creates a grey area where only a few directors would know the true proper standing while channeling the proper information to the other directors. Having proper requirements for who can be appointed as a director, within the Companies Act,[492] is vital, as this can also help with better accountability and holding directors liable for their actions.

The same can be applied in my opinion to the audit committee. The audit committee is appointed to assist the company especially regarding the financial standing. As mentioned previously, if any financial fraud or other illegal activity is not detected, then the audit committee would be accountable to the shareholders.[493] All the legislation I explored showed the importance of audit committee members having financial literacy to be able to perform their duties to the best of their abilities and towards the company. The audit committee have the same liability as that of the board of director. The audit committee needs to present accurate information and it would be impossible to do if they do not have financial literacy. The Companies Act,[494] already has a provision which states that if the Minster provides requirements for any skills or education that the audit committee members need, they need to have these required skills or qualifications if they want to serve on the audit committee. Both parties (audit committee and the board of directors) will be better able to identify financial mistakes and those responsible for any misconduct, saving companies millions in expenses.

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It is important for a company to create good corporate governance and business ethics, and it is my belief that if the board of directors and the audit committee have financial literacy that is not only prescribed within the Companies Act ,[495] making it apply to all companies unlike just having it in the MOI, and not having it apply to all companies, it would not only promote good corporate governance and business ethics but also be a sure way to help combat financial misconduct. Though it would not eradicate financial misconduct immediately, having the small stepping stones will help with the progress of South Africa's economy and the way companies pay a role in it.

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[492] Act 71 of 2008.
[493] Giles JP. *Evidence on the relationship between audit committee characteristics and the quality of financial reporting* (Doctor of Philosophy, State of New Jersey University, 1998) pg. 6.
[494] Act 71 of 2008.
[495] Act 71 of 2008.

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It will be valuable to see how companies would progress if financial literacy became a requirement for all the board of director members and the audit committee and how companies would better deal with those individuals that commit misconduct.

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