

# Comments on the Draft Code of Governance Principles for South Africa

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Date: 17 April 2009

## 1. Introduction

The Draft Code of Governance Principles for South Africa – 2009 (King III) was published for public comment during February 2009. We commend the members of the King Commission with this ground-breaking draft Code. Our comments on King III relate specifically to its application and relevance to non-profit organisations.

*King II* made a number of important recommendations from which non-profit companies could benefit. King II was, regrettably, not clear on its application to section 21 companies.<sup>1</sup> The value of King II to the non-profit sector was, arguably, not fully optimised given its failure to specifically refer to non-profit companies. King III has also concentrated on commercial entities and whilst there is no doubt that it can add significant value to non-profit entities, it may once again lose the opportunity to inspire effective governance within the non-profit sector. This document is aimed at identifying the fundamental differences between non-profit and for-profit entities with the view to encouraging a deeper scrutiny and reflection on non-profit governance within the final version of King III.

## 2. Companies Bill, 2008

The Companies Bill, 2008 marks a noticeable improvement in its coverage of the non-profit company compared to the existing Companies Act where a clumsy attempt was made to accommodate non-profit companies. Section 7 (h) of the Bill states that the purpose of the new Act, in relation to non-profit companies, is: *“to provide for the formation, operation and accountability of non-profit companies in a manner designed to promote, support and enhance the capacity of such companies to perform their functions”*. This terminology echoes the state’s responsibility to non-profit organisations contained in section 3 of the Nonprofit Organisations Act.<sup>2</sup>

Since the publication of its Guidelines for Corporate Law Reform in May 2004, the Department of Trade and Industry has made a notable effort to take into account the views of the non-profit sector on corporate law reform. The Department has set an example by taking into account the views and submissions of the non-profit sector and by producing a Bill that reflects that process. For reasons motivated below, we suggest that King III can further build on the process embarked upon by the Department of Trade and Industry to give more dedicated attention to non-profit entities.

## 3. The application of King III

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<sup>1</sup> The King II Code in essence applies to; companies listed on the Johannesburg Stock Exchange, banks, financial and insurance entities, and public sector enterprises and agencies falling under the Public Finance Management Act and the Local Government Municipal Finance Management Act.

<sup>2</sup> Section 3 reads: **3. State’s responsibility to nonprofit organisations.**—Within the limits prescribed by law, every organ of state must determine and co-ordinate the implementation of its policies and measures in a manner designed to promote, support and enhance the capacity of nonprofit organisations to perform their functions.

King III applies to *'all entities regardless of the manner and form of incorporation or establishment'*. It would accordingly apply to non-profit companies and voluntary associations that are constituted as body corporates. It would not apply to non-profit or business trusts because the South African courts have consistently found that trusts are not separate legal entities. King III further states that each entity should consider which approach would best suit its size and complexity.

King III is wide in its application, but its content is visibly biased towards commercial companies rather than non-profit entities. The following examples illustrate this:

- a. The word 'business' appears over one hundred and fifty times in the report whilst the term 'non-profit organisations' is referred to *once* under the chapter dealing with the management of stakeholder relationships.
- b. Under its preface, the ultimate compliance officer is considered the 'market place' (see page 8).<sup>3</sup> The market place, in this context can only be construed as the place where trade takes place, which is based upon the supply and demand concept. This market place cannot be construed as the ultimate compliance officer for non-profits because non-profits are not set up with the main objective of making a profit. In contrast, the market-failure theory is commonly offered as one of the reasons for the continued existence of non-profit organisations.
- c. The changeover from sustainability reporting to integrated sustainability performance and reporting has seemingly been influenced by concerns amongst business decision makers (see page 13).
- d. The board's paramount responsibility is considered to be the positive performance of the company in creating value for its shareholders<sup>4</sup> and the company (see page 21).
- e. The board should seek to drive *business* performance without contravention of any laws and regulations (see page 28).

It is clear that King III is most applicable to commercial business. Despite this, it holds significant value for non-profit entities, but this value may get lost within a Code that is premised on governance within the commercial market.

#### **4. Key differences between non-profits and for-profits**

Non-profit entities inherently function differently from for-profit entities which should translate into distinct governance implications. The following two key distinctive features highlight such differences:

- i. For-profit entities are formed with the main objective of generating financial profits by conducting business in the market place. The success or failure of a for-profit entity is ultimately measured against this main objective. Its continuation is futile if it fails in the market place. Conversely, the main objective of a non-profit entity can never be to generate profits. Consequently, a non-profit entity's success cannot be measured against its ability to generate profits. The main objective of a non-profit entity is first and foremost to pursue a broader public objective or to promote some form of social change. Its performance in the

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<sup>3</sup> The broader context of King III is clearly focused on the market place within the commercial sense.

<sup>4</sup> The Code draws a clear distinction between shareholders and stakeholders.

commercial market place is not the primary objective and therefore cannot be used as a measure of success or failure.

- ii. Shareholders of for-profit entities typically share in the profits yields of such entities. Such is their reason for becoming shareholders. Non-profit entities do not have shareholders. Accordingly, any financial surplus generated by the non-profit entity, as part of its secondary objectives, must be used to pursue the objectives of the non-profit entity.

## 5. Implications for governance of non-profit entities

The abovementioned differences result in non-profit entities having to adhere to distinct governance practices, in comparison to for-profit entities. In particular:

- 1) **The paramount responsibility of the board** - The board's paramount responsibility within a non-profit entity cannot be, as King III puts it; "the positive performance of the company in creating value for its shareholders".<sup>5</sup> This is the focal point of governance for a for-profit entity. The focal point of governance for a non-profit entity is public benefit not shareholders. The Companies Bill requires that the non-profit company be incorporated for public benefit or an object relating to one or more cultural or social activities, or communal or group interests. The promotion of religion, the arts, science, education, charity, recreation, or any other cultural or social activity or communal or group interests are listed as objectives for a non-profit company in terms of section 21 company of the existing Companies Act. King III's philosophical approach towards governance is based upon what is considered the paramount responsibility of the boards of commercial entities, not non-profit entities. Objectives for non-profit entities can, for example, be directed at social value i.e. changing behaviour, conduct, attitudes or beliefs which bring social value to communities, not shareholders.
- 2) **Measuring board performance** - The performance of governance should be measured against its paramount responsibility. If the paramount responsibilities are different for non-profit and for-profit entities, the measurement of the performance of the respective boards must be different. King III fails to draw this distinction. Furthermore, the reward for taking risk is different for non-profit entities compared to for-profit entities. *Firstly*, boards of non-profit entities may be more risk averse in directing the affairs of the entity as there is no potential for personal financial reward. *Secondly*, board members of non-profit entities most often serve in that capacity on a part-time basis and therefore have less time at their disposal to attend to the affairs of the entity. These distinctions are not evident from the King III. Boards of non-profits and for-profits cannot therefore, appropriately, be measured according to the same standards.
- 3) **Ownership of entities** – The concept of 'shareholders' implies ownership (or joint-ownership) of the legal entity. King III is based on the premise that shareholders (and directors) have vested private interests in non-profit entities. Non-profit entities are not constituted on this premise as members and office-bearers ordinarily do not have ownership rights to property of the non-profit entity. The governance of non-profit entities should *not* be based on the premise of ownership or vested private interests.

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<sup>5</sup> Paragraph 3 on page 21.

- 4) **The ultimate compliance officer** - The market place should not be the ultimate compliance officer for non-profit entities because the market place is not its main prerogative (see page 8). Although non-profit entities can carry on trading activities, it is with the intention of supporting its public objective – any trading activities are ancillary activities. As mentioned earlier, the market-failure theory is commonly offered as one of the reasons for the continued existence of non-profit organisations. Non-profit entities rely to a large extent on philanthropic support which is not based on the same forces of supply and demand on which the market place is based.
- 5) **Motivation for serving on boards** – Boards of non-profit entities are, as matter of course, non-executive<sup>6</sup> given their reliance on donor support. The motivation to serve on the board of a non-profit entity would therefore go beyond reasons of personal remuneration and profit. The motivation is ordinarily found within the objectives and activities of the non-profit entity. Non-commercial values are therefore indispensable motivating factors for non-profit boards. These non-commercial values, often of a social nature, are the driving force behind the governance of non-profit entities.
- 6) **Composition of the board** - King III recommends that boards should comprise a balance of executive and non-executive directors, with a majority of non-executive directors. This recommendation, again, confirms the underlying commercial approach towards governance explicit in the King III. As pointed out in paragraph 5) above, boards of non-profit entities are typically non-executive.
- 7) **Standing committees** – King III further recommends that, unless legislated otherwise, the audit, risk, remuneration and nomination committees should be standing committees. Smaller entities do not have to adhere to this, but should ensure that these functions are appropriately addressed by the board. Boards of non-profit entities (whether big or small) are typically non-executive and should accordingly fulfil the function of an audit or remuneration committee. Having to appoint standing committees in a context where it is already hard to find board members is an inappropriate recommendation for non-profit entities.

## 6. Conclusion and recommendation

The above key differences between non-profit and for-profit entities and its implications for the governance of non-profit entities cannot be ignored. King III's professed application to all legal entities may cause more harm than good to the South African non-profit sector as it, inadvertently, ignores the distinctive values on which the South African non-profit sector is based. These distinctive values have, for example, played a significant role in South Africa's struggle against apartheid. It is indeed these entrenched values within the non-profit sector that contributed towards the democratic dispensation where the markets can operate freely. Introducing a commercial governance model for non-profit entities will inevitably lead to suppression of the non-profit sector's distinctive values. Non-profit and for-profit entities are formed and governed on different ideologies.

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<sup>6</sup> Non-executive cannot automatically be equated with independent within the context of non-profit entities because non-remunerated board members may still be intimately involved with a non-profit entity as a volunteer or as a member of its subsidiary structure.

It is questionable whether a few changes on the surface will sufficiently address the shortcomings of King III in relation to non-profit entities. The 'comply or explain' concept is furthermore inadequate to deal with the fundamental differences alluded to above. King III is presented with the opportunity of also giving special consideration to the governance of non-profit legal entities in order to make a lasting beneficial impact on the non-profit sector. In doing so, King III would also address another shortfall of the Sarbanes-Oxley Act, which is the confusion it created with reference to its applicability to non-profit organisations in the USA.

Given the above factors it is recommended that a sub-committee be appointed to develop a chapter within the King III code that will specifically address governance matters within non-profit organisations.

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