

## King III: Comply vs Apply – What's the difference?

By **Lindie Engelbrecht**, Chief Executive, Institute of Directors in Southern Africa (IoD)

**One of the subtle changes in the King III draft report - released 25 February 2009 - is the shift from 'comply or explain' to 'apply or explain'. However, to the uninformed, the question may be what is the difference and the informed may be wondering, why the difference?**

The King II Report was drafted with 'affected entities' in mind. Essentially these included listed companies, financial institutions and public entities. Private companies and other entities, although not specifically included in the definition were urged to comply on a voluntary basis. Thus, many private companies and other entities did not regard the King II code applicable to their companies and did not comply.

The framework of 'comply or explain' was applied mainly by listed companies, as a result of the requirement for compliance in the JSE listing requirements, and in the reports of many companies, it was clear that companies complied with those principles that they agreed with or were cost effective, and then did not comply with other principles. This resulted in many companies reporting on 'substantial compliance' on certain principles and not the code read as a whole.

In our attempt to broaden the scope of the King code, the King III code is drafted without any particular 'affected' companies in mind. The code applies to all companies, public entities, private companies and all other forms of businesses.

The aim of this objective is to ensure that all forms of business apply the basic principles of good governance in South Africa. This decision clearly resulted in the question of how a small company could comply with the principles of good governance, the same as what was expected from a large listed company. The focus was on compliance, still on the form over the substance and one would expect some form of comparability. To expect a small company to comply with the principles the same as a listed company would have significant cost implications and, we believed, have many unintended consequences.

Therefore, the King committee decided to draft the principles on an 'apply or explain' basis to prevent these cost implications and to ensure that the focus

is on 'application' versus 'compliance'.

For this framework to work effectively, the principles were also drafted at a sufficiently high level to ensure that all organisations would be able to apply these principles for their particular circumstances.

The difference is best explained through an example. One of the principles of the King III Code is that the board is responsible for the process of risk management. When a large listed company applies this principle, it may require the establishment of a risk committee, a chief risk officer and several other process changes to achieve this principle.

A small one-man concern should also apply this principle, however as the person who 'is the board' this person may want to consider and note the top ten risks facing the entity and consider the applicable controls necessary to mitigate these risks.

Both entities have applied the principle, however very differently to fit the nature, size and complexity of the organisation. The explanation needed in both these cases is to set out how the principle is addressed and to give stakeholders the opportunity and the information to assess if the principle has been adequately addressed.

You may also find that some entities do not apply a particular principle, for example, a small business may decide that the company does not need a company secretary. In this instance it would be required of this business to explain that it has not applied a principle and what the reasons were, again providing the information to stakeholders to question the appropriateness of the decision.

The 'apply or explain' basis allows every organisation to apply all the principles of the code as it best meets the objectives of the entity and to focus on the substance rather on the form of application. ■



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