

RISK MANAGEMENT DISCLOSURE PRACTICES IN ACCORDANCE WITH KING II AND III: THE CASE OF SELECTED JSE LISTED COMPANIES

Heleen Janse van Vuuren

North-West University (Vaal Campus), South Africa

E-mail: Heleen.jansevanvuuren@nwu.ac.za

—Abstract —

The ongoing collapse of large international companies could have been partially prevented if good corporate governance principles and, more specifically, effective risk management practices had been implemented and adhered to. Research reveals that the majority of financial institutions in Europe do not manage risk effectively and the global financial crisis proved that excessive risk-taking can result in corporate failure. Similar trends are prevalent in South Africa. The aim of this research was to investigate the compliance of Johannesburg Stock Exchange (JSE) listed companies with recommended risk management practices and disclosure requirements after the introduction of King II and III. To achieve this the annual reports of selected JSE listed companies were evaluated to establish the quality of their reporting on risk management practices as recommended in King II and III. The results of the study indicated that the minority of the companies investigated, fully complied with all the recommended requirements. This study contributed to literature by showing that although disclosure on risk management practices improved significantly since King II became operational in 2002, companies still did not adhere to all the requirements as stipulated even after King III became effective in 2010. The finding, therefore, supports the notion that full compliance is an evolutionary process, rather than a revolutionary process and will therefore only be achieved over time.

Key Words: *Corporate governance, risk management disclosure, King II, King III, JSE listed companies*

JEL Classification: G31, G34

1. INTRODUCTION

The demise of major international companies in past years could have been partially averted if good corporate governance principles were adhered to in these companies. Although there will always be risk involved in most business decisions, Kirkpatrick (2009) stated that the financial crisis of 2008/2009 could largely be assigned to non-fulfilment and deficiencies in corporate governance practices which fail to serve their purpose to protect entities against excessive risk taking. Risk management is therefore a prominent aspect of good governance, which necessitates the implementation of effective risk management practices and the proper disclosure thereof in the annual financial statements. Okeahalam (2004) suggested that better corporate governance resulted in better performance on all business levels. A report by the Organisation for Economic Co-operation and Development (OECD, 2014) indicated that corporate failures, due to major institutions' risk management practices, especially in the financial sector, but also in other sectors, made headline news for many years. These failures were not always due to flaws in financial risk-taking, but could also be the result of Accounting fraud (e.g. Enron and Worldcom) and foreign bribery (e.g. Siemens). The OECD (2014) recognised that although good corporate governance practices alone may not have prevented these corporate failures, but could have at least minimised the negative effect of those collapses. Boards would have acknowledged the risks companies were taking, or recognised deficiencies in the risk management systems (providing they did not engage in excessive and careless risk-taking themselves), if good corporate governance was executed during the time of the development of the financial problems. Some of the catastrophic impacts on the global economy may have been reduced if effective corporate governance was in place. The introduction of the King codes on corporate governance in 1994, 2002 and 2009 emphasised the importance of risk management as an essential part of good corporate governance.

Company directors need to acknowledge the fact that risk is an inherent part of any organisation's existence and, if not dealt with properly, it has the potential to paralyse an otherwise successful growth strategy. Therefore, a more pro-active strategy in dealing with the risk management framework should be followed as part of effective corporate governance, Valsamakis et al. (1996) stated that risk management is a managerial function whose duty is to protect the business in total against the adverse consequences of risk in order to reduce the severity of losses. Konstans et al. (2011) suggest that the aim of effective corporate governance is to guide the overall strategic direction of the entity and as the current operations,

together with other important areas. These areas include risk management, financing activities and replacement planning amongst others that jointly drive the company towards the achievement of its objectives. One of the main focus areas dealt with by the King Committee on corporate governance is the management of risk as well as the appropriate disclosure of risk management practices.

Kirkpatrick (2009) and the OECD (2014) opined that the financial crises in the previous decade could partially be attributed to poor corporate governance practices which resulted in excessive risk-taking. This study attempts to show that even after the implementation of King II in 2002 and King III in 2009, companies still lack full adherence to the recommendations of these reports, with specific reference to the disclosure of risk management practices. Even companies that seem to do well with disclosure on risk management practices, lack in-depth disclosure. A lot of emphasis is placed on quantifiable risks like financial risks, but very little disclosure was done on risks like strategic risks, technological risks, disaster recovery risks and IT risks (Van Vuuren, 2006). Ntim et al. (2013:373) found that risk disclosures have mostly improved over the ten-year period (2002 to 2011) for the companies evaluated by them. However, the level, focus and quality of the risk disclosures differ vastly between the companies. The authors suggested that more attention should be given to disclose more “forward-looking”, “quantitative” and “monetary oriented risk information” that will be more useful to stakeholders. Despite a gradual improvement in risk disclosure practices year on year, their study indicated that only 56 percent of the companies evaluated, included disclosure of high quality on total corporate risks. Although companies mostly believed that they were adhering to effective practices as far as risk management is concerned, this was not evident to the users of the financial statements because the disclosure thereof was poorly done. A survey done by PricewaterhouseCoopers (PWC, 2012) confirmed that, even after the implementation of King III in 2009, many companies are still not complying with the recommendations of the codes. This indicates that full adherence to all the recommendations is an evolutionary process that may only be achieved over time.

2. LITERATURE STUDY

From several publications (e.g. PWC, 2012; Ntim et al., 2013; OECD, 2014) , it seems that many companies still do not meet the requirements of implementing a formalised risk management process in accordance with the recommendations of King II and III. Annette Hieber, a Basel II specialist in South Africa, conducted a survey in 2003 which revealed that seven out of ten big financial institutions in

Europe did not manage risk effectively (Hieber, 2003). Although no major survey was done by Hieber in South Africa, she opines that the picture locally may be even worse.

A survey by Griffiths (2001) on compliance with corporate governance principles in the late 1990's and early 2000's indicated that companies did not take the issue of internal control and risk management very seriously. Griffiths (2001) found that only 6 of the 100 companies surveyed included a statement by the directors regarding the effectiveness of their company's risk management practices. Since 1994, the King Codes of corporate practice and conduct were developed by IoDSA, which formalised the implementation of good governance practices. Even after this formalisation Van Vuuren (2006) found that only 12 percent of companies fully complied with the disclosure requirements on risk management after the implementation of King II and the possibility exists that full implementation will even be slower after the implementation of King III, as the latter follows principles-based approach, whilst King II followed a rules-based approach. Agoglia et al. (2011) conducted a study on the principles-based versus rules-based approach and found that both the approaches have advantages, as well as disadvantages. The principles-based approach is a more flexible and lenient approach to governance disclosures, but may be abused if companies fail to explain their deviations from the recommendations in King III (KPMG, 2009). KPMG (2009) found that although risk management under King III remains as important as under King II, the implications are that the board of directors will have to focus more on risk management in order to fully incorporate it into the daily management of the business and that the disclosure of key risks will need more "articulation and stakeholder management".

The International Finance Corporation (IFC, 2013) defines corporate governance as "the structures and processes by which companies are directed and controlled. Good corporate governance helps companies operate more efficiently, improve access to capital, mitigate risk and safeguard against mismanagement." Governance means "to control" and the introduction to King III (IODSA, 2009:9) states that "good governance is essentially about effective leadership, sustainability and corporate citizenship". All of these are inter-connected in complex ways which can create opportunities and risks. Good corporate governance practices are pivotal to ensure enhanced access to external capital and ongoing improvement in an entity's performance, which will result in sustainable economic development and growth. Simply stated, corporate governance refers to a set of practices in an organisation to ensure fairness, accountability and

transparency for all its stakeholders. (IODSA, 2009). Roe (2004) posits that corporate governance refers to the relationship between the board of directors, senior management and the shareholders, and the mechanisms in place to assign authority amongst the aforementioned. This relationship will dictate the decisions made at the top of the company. Konstans et al. (2011) argue that corporate governance is crucial to ensure the appropriate accountability and transparency in the running of the business, for the long-term benefit of all its stakeholders. Good corporate governance should ensure that resources are efficiently used and that accountability for the use of thereof is properly assigned. The interests of the company, individuals and the society should be aligned as far as possible.

Abor and Adjasi (2007:111) define corporate governance as “the process and structure used to direct and manage the business affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long-term shareholder value, whilst taking into account the interest of all stakeholders”. To summarise the afore-mentioned, corporate governance refers to the quality of the executive management and the board of directors in terms of leadership, risk management, accountability and reporting. It also indicates what mechanisms are in place to recognise, assess, monitor and regulate the risks that are related to the successful achievement of the strategic and operational goals to ensure sustainability. Risk can be defined in various ways but in common terms it can be described as “... the possibility of adverse consequences happening” (Olsson, 2002:5). Although risk is mostly viewed as negative and all efforts usually focus on the prevention of potential losses, there is always a possibility that great benefits can be obtained by taking the right risks. All these need to be disclosed in a transparent manner to the relevant stakeholders in a true, acceptable and accurate way.

The Institute of Directors in Southern Africa (IoDSA) established the King Committee on corporate governance in 1992 and they were tasked to investigate corporate governance principles from a South African perspective. This resulted in the publication of the first King Report in 1994 whose aim was to encourage the implementation of effective corporate governance practices and to recommend standards of conduct for boards of directors in South Africa. King I encouraged an integrated approach to effective governance, by taking into account stakeholder interests, whilst exercising sound financial, social, ethical and environmental This King Report was considered as a cutting-edge code of corporate governance in South Africa, and Banhegyi (2007:317) referred to it as the most effective summary of the best international practices in corporate governance. The

following reports were published by IoDSA: King I in 1994, King II in 2002, King III in 2009 and the draft King IV report that was released for public comments on 15 March 2016. All Johannesburg Stock Exchange (JSE) listed companies are required to comply with the latest King Reports as soon as they become effective. (JSE listing requirement, 2012, Section 7F5 and Section 8.63)

The second King Report on corporate governance was published in 2002. Although it is optional, the JSE required listed companies to comply with the recommendations of the latest effective King Report, or to explain the reasons for non-compliance. During the development of the King II report, a number of task teams were established and one of them was the “*Internal Audit, Control and Risk management task team.*” Their purpose was to investigate and to recommend best practices on risk management for boards of directors to use as criteria in order to adhere to good corporate governance principles. The increasing importance of proper risk management and the disclosure thereof became very prominent in King II.

On 1 September 2009 the King Committee released the revised Code on Governance Principles for South Africa (King III), which became effective from 1 March 2010. The revised report puts an “escalating emphasis on sustainability and embraces an overall risk-centric approach of governance (SAICA,2013b:1)” The code needed to be revised, because a number of the principles that were included in King II were absorbed as legislation in the new SA Companies Act of 2008. According to the Introduction paragraph of King III, the development of King II and King III continues to position South Africa as a global leader in good governance (IoDSA, 2009). Although King III follows a “principles-based” approach and cannot be legally enforced (except as embraced by the JSE Listing requirements), all entities are urged to comply with the principles of the Code “insofar as is practicable” (SAICA, 2013b:1). In King II it was only recommended that an audit committee should be appointed, whereas King III recommends that an audit committee as well as a risk committee should be appointed, strengthening the importance of risk management. In King III, risk management also became more formal, as a board approved risk management framework is required.

King II (IoDSA, 2002) (Section 2, Chapter 1, par. 4 & 5:73) defines “risk management as the identification and evaluation of actual and potential risk areas as they pertain to the company as a total entity” Planning, organising and controlling of resources are an integral part of the risk management process,

which aims to minimise the effect of all risks to tolerable levels for all stakeholders. SAICA (2013a:1) also suggested that risk management refers to the practices in use to identify, evaluate, monitor and control risks to ensure the successful achievement of operational as well as strategic goals to assure sustainability. An important factor of risk management is that it must be practiced by all employees of the entity in every part of their daily work. However, the board of directors remains responsible for the overall risk management and internal control systems within an organisation. The board should, however, nominate a dedicated committee (risk committee or audit committee) embodied by executive and non-executive directors, as well as senior management members to help them in the execution of their responsibilities in this regard as recommended in King III. (IoDSA, 2009)

The modern business environment is highly complex and new, complex risks emerge on an ongoing basis, which can have a major impact on shareholders' value. Risk management is a fundamental component of good governance and after the collapse of Enron, WorldCom and other corporate failures, company boards have realised the urgency of improvements to their governance systems. The recommendations in the King codes on corporate practices and conduct are very clear on how to ensure good and solid corporate governance in every organisation, and that the effective management of risks is an inherent part of good governance. Risk management should not be merely used as a defensive action, but rather as a key element in strategic planning and a management tool to create sustainable shareholder value and customer satisfaction. King III (IoDSA, 2009) emphasises that the main challenge for leadership, is to focus on sustainability issues, as strategy, risk, performance and sustainability are all interconnected and stakeholders need to see evidence of this in the disclosure in the financial statements.

The Institute for Chartered Accountants of England and Wales (ICAEW, 2002) states that risk taking is essential in a business environment, but the optimal balance between risks and rewards must be obtained, whilst tracking opportunities to earn the maximum rewards for the company. Ennouri (2013) concludes that risk can be uncertain events, which can have positive effects (opportunities), or a negative effects (hazards) on the business.

The importance of risk management and the proper disclosure there-of is evident from the prominence this aspect of corporate governance is given in both King II and King III. Paragraph 3.2 of the King II report refers to the application and

reporting of risk management and requires the board of directors to do certain minimum disclosures in the annual report in respect of risk management. King III (IoDSA, 2009) devotes a full chapter (Chapter 4) on the governance and disclosure of risk, which underlines the increasing importance of risk management as a fundamental part of good governance. All the recommendations with regard to risk management and risk management disclosures as per King II are still very relevant and King III requires even more detail disclosure with respect to risk management. Principle 4.10 of King III (IoDSA, 2009:39) states that “the board should ensure that there are processes in place that enable complete, timely, relevant, accurate and accessible risk disclosure to disclose any undue, unexpected or unusual risks in the pursuit of reward as well as any material losses and the causes of the losses. They should also disclose its views on the effectiveness of the risk management processes. PWC (2016) concluded that the King III report requires from the board of directors to have practices in place to ensure that risk management does not become a range of actions that are disconnected from the realities of the real business of the entity. King III places a lot of prominence on leadership of and involvement from the board to ensure that the board is satisfied with the practices in place to manage risk in the organisation. PWC (2016) indicated that the board should disclose on what evidence they base their conclusions on the effectiveness of the risk management system in their entities, to fully adhere to the requirements. PWC (2016) stated that these could be achieved by providing disclosure on:

- The governance structures like audit- and risk committees
- The annual risk management plan
- What risk management practices are in place and what methods are used to assess and monitor the risks on a continuous basis.
- The risk appetite and tolerance of the organisation and what risks were considered in specific business decisions
- The assurance to the board on the effectiveness on specific risks.
- The board’s satisfaction on the effective management of risk

From the afore-mentioned it is evident that risk management and risk disclosure forms a very important part of effective corporate governance practices and that the financial disasters of the world will remain a reality and will continue occurring until proper risk management is a high priority for every director, manager and employee of the company. Regulations like the King code, Turnbull and Basel share the same objective which is to protect shareholders and public

interest from poorly managed businesses and the only way that stakeholders can be certain that these practices are adhered to, is if the relevant information is properly disclosed in the financial statements (Van Vuuren, 2006). The objective of this study was therefore, to determine if companies that were evaluated, fully complied with the requirements of good corporate governance practices, which could be an indication of their acknowledgement that good corporate governance is essential in any business. Full compliance would have also indicated that these companies accept that risk management and the disclosure there-of, is an integral part of effective governance, which adds value to the entity and reduces the cost of capital, ensuring effective financing from investors.

3. METHODOLOGY

A comprehensive literature review was conducted on corporate governance, risk management and the disclosure thereof. Secondary data available in literature was used to compare the findings of Van Vuuren (2006) on the risk disclosure adherence after the implementation of King II and a follow up survey done by PWC in 2012 after the implementation of King III.

In Van Vuuren's (2006) study, the financial statements of 80 JSE listed companies (as per the Financial Mail Top 100 companies list, 2003, 28-36) in the industry sector were evaluated to determine their compliance with the King II requirements on disclosure of risk management practices. PWC developed a checklist in 2002, to evaluate the compliance of companies, with the recommendations of the second King Code that became effective in 2002. This checklist (referred to as the "The King Code 2002: Self -assessment Questionnaire") included 11 recommendations as per King II, with the corresponding compliance requirements as per the self-assessment questionnaire developed by PWC in 2002 (Table 1). This checklist could be used by companies to ensure proper risk management disclosure, to adhere to the requirements of King II, and was therefore used in this study, with the consent of PWC, to evaluate the reporting on risk management in the selected companies. This checklist with the 11 King II recommendations and the compliance requirements identified to ensure proper risk disclosure, will be discussed in the next section together with the results obtained from the evaluation.

PWC conducted a similar assessment in 2012 on the integrated reports of the top 100 companies listed on the JSE. This assessment focused on all the pivotal areas of King III and the purpose was to determine to what extent companies adhered to the recommendations of King III, as it became effective for all companies with

financial year-ends on or after 1 March 2010. For purposes of this comparative study, only the findings on the disclosure of risk management will be discussed in the next section.

4. RESEARCH FINDINGS

Table 1 provides recommendations in respect of risk management disclosures as per Section 2 of the King II code on corporate governance, as well as the check-list developed by PWC to determine if companies comply with these recommendations. The findings of the evaluation done on the adherence to these recommendations by the top 80 JSE listed companies, is also shown in table 1.

Table 1: Compliance with King II in respect of risk disclosure

| | Recommendations of King II | Compliance requirement as per the check-list done by PWC | % compliance |
|---|--|---|---------------------|
| 1 | Responsibility of the board of directors for the full process of risk management in the company | Is it disclosed in the annual report that the board of directors is accountable for the process of risk management and the system of internal control? | 88% |
| 2 | The board of directors should periodically evaluate the effectiveness of the risk management process | Is it disclosed in the annual report that the process of risk management and the system of internal control are regularly reviewed for effectiveness? | 95% |
| 3 | The board of directors should set risk strategies and policies in liaison with the executive directors and senior management | Is it disclosed in the annual report that the board of directors is accountable for establishing appropriate risk and control policies? | 93% |
| 4 | Risk management policies should be clearly communicated to all employees | Is it disclosed in the annual report that the board of directors is accountable for communicating appropriate risk and control policies through the organization? | 33% |
| 5 | The company should have implemented an effective ongoing process to identify, measure and proactively measure risk | Is it disclosed in the annual report that a process for identifying/evaluating/managing significant risks was in place throughout the year under review and was in place up to the date of approval of the annual report? | 85% |
| 6 | A comprehensive system of control that is focused on risk mitigation should exist, to ensure achievements of objectives. | Is it disclosed in the annual report that an adequate system of internal control exists to mitigate the significant risks to an acceptable level? | 88% |

| | Recommendations of King II | Compliance requirement as per the check-list done by PWC | % compliance |
|----|---|--|---------------------|
| 7 | The organisation's risk management and internal control practices should contribute to the development of robust business operations. | Is it disclosed in the annual report that the system of internal control is designed to manage, rather than eliminate, risk of failure or opportunity risk? | 74% |
| 8 | The risk management and internal control model should provide the Board of director's reasonable assurance on the effectiveness and efficiency of the organisation, the safeguarding of its assets, the compliance with laws and regulations and the reliability of its reporting | Is it disclosed in the annual report that the system of internal control can only provide reasonable, but not absolute assurance? | 91% |
| 9 | A documented and tested business plan should exist to ensure continuity of business critical activities | Is it disclosed in the annual report that documented and tested business continuity plans exist to ensure continuity of business critical activities? | 34% |
| 10 | The board of directors should regularly receive and review reports on the risk management process in the organization. | Is any additional information that can assist in the understanding of the risk management processes and system of internal control disclosed in the annual report? | 73% |
| 11 | The board of directors should appoint a committee to assist it in discharging its responsibilities for risk management. | Is it disclosed that a risk or audit committee has been appointed in the organisation? | 84% |

Source: Van Vuuren (2006)

Table 1 reveals that the majority of companies evaluated complied to some extent with most of the recommended requirements. However, further analyses showed that only 10 (12%) of the 80 companies investigated, fully complied with all the disclosure requirements on risk management and internal control as recommended in King II. It also showed that two major areas of risk disclosure still needed a lot of attention: Only 26 (33%) of the companies investigated disclosed on the communication of risk management practices through-out the organisation and only 27 (34%) provided any disclosure on disaster recovery planning. Burnaby and Hass (2009) suggested that all the employees of an entity should be involved in and educated about risk and risk management. It is doubtful whether it can be claimed that risk management in a company is effective if these two very important aspects are not adhered to.

In a similar study done by PWC (2012) on the top 100 companies listed on the JSE to determine to what extent companies adhered to the governance recommendations after the implementation of King III, it was found that as far as risk management disclosure is concerned, companies followed the usual trend of doing a high-level disclosure, but did not support this assessment with additional information in order to be useful to users. Although 90 percent of the companies evaluated disclosed their main risks and how these were mitigated, only 25 percent of them disclosed their risk appetite and level of risk tolerance, which is a prominent recommendation of King III. This is disappointing as it could be expected by stakeholders that this information should be readily available if good risk management practices are exercised. PWC (2012) also found that the majority of the boards of directors of the companies evaluated accepted that they are responsible for risk management (91%) and its alignment with the strategic objectives of the organisation (86%). The most of the boards also disclosed that they have integrated risk management into the daily activities of the company (77%), but very disappointing was that only 59 percent included a report on how they assessed the effectiveness of risk management practices in their organisations. This is a concern as this is a very important recommendation of King III. On face value it seems if companies are making progress regarding the management of risk and the disclosure there-of, but much can still be done in this regard, as the number of companies that fully complies with all the recommendations of the King reports, remain fairly low. This can be an indication that companies need specific guidelines, or a framework, on exactly how to do their risk reporting to ensure full compliance.

Although King III (2009) expects the board to disclose any current, imminent or envisaged risk that may threaten the long-term sustainability of the company, it may be a challenge to decide how much and what information to disclose, as guidelines on proper disclosure are limited. The risk exists of disclosing only general information, which will not provide users the relevant insight into the different risks the company faces. This applied pressure on the board of directors and top management to be directly involved in putting a formal, well documented risk management process in place to ensure its effectiveness (Burnaby & Hass, 2009).

5. CONCLUSION AND RECOMMENDATIONS

The objective of the study was to determine if the listed companies that were evaluated fully complied with the recommendations as set out in the King reports

on corporate governance, with the focus on risk management and the disclosure there-of. Full compliance might have indicated that the Boards of these companies recognised the value-adding effect of good corporate governance practices which include, amongst others, effective risk management practices and the proper disclosure there-of. The literature revealed that risk is a crucial part of a competitive economy and a good balance between risk and reward should be found by the board of directors. Too much risk can be fatal, whilst too little risk can result in a business not pursuing rewarding and profitable opportunities. Attempts to avoid all risks can result in the sacrifice of positive rewards. Therefore, risks should be effectively managed. The disclosure of risk management practices and corporate governance in the financial statements should be of such high quality, that stakeholders should have no doubt that an appropriate balance between risks and rewards exists in the company.

A “rule based” approach was followed by King II, which could result in a “mindless” response to the recommendations of the code. This resulted in King III to be changed to a “principles-based” approach to give recognition to the fact that the board of directors will always do what is best for the organisation, by implementing a principle even if it is different from what was recommended in the code. This approach gives companies more flexibility. However, the risk exists that it might be abused as they can try and explain their way out of King III. King III is not prescriptive of exactly what risks should be assessed, but it actually puts more responsibility on the board as they are required to review a register of the entity’s main risks on a regular basis, as well as how these are mitigated. The board should report on this in the annual report. King III emphasises sustainability, thus all factors that could threaten sustainability should be included in the risk assessment. The board should determine and report on the risk appetite and risk tolerance levels of the company and also report on the effectiveness of risk management practices in the company.

The conclusion that can be drawn from this study is that, if the disclosure of risk management practices in the annual financial statements of the companies that were evaluated, is a true reflection of the actual status of the implementation of effective risk management practices in these companies, much work still needs to be done by company boards in terms of disclosure to fully adhere to all the recommendations in the King code of practices and conduct. A reason for this might be that guidelines for disclosure of risk management are interpretative and inconsistent. The stakeholders’ ability to interpret the risk management disclosure may therefore vary, as disclosure in financial statements and integrated reports are

inconsistent and vary from company to company. It is, therefore, recommended that a uniform framework should be developed of exactly what should be included in the integrated report of a company in respect of disclosure of risk management practices and the effectiveness there-of.

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