

SOUTH AFRICA'S KING III:

HIGHLIGHTING THE NEED FOR A SEPARATE NON-PROFIT GOVERNANCE CODE¹

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I. INTRODUCTION

The King Code of Governance Principles (the Code) and the King Report on Governance for South Africa (King III) were published on 1 September 2009 by the King Committee on Corporate Governance. This Committee was established in July 1993 by the *Institute of Directors in Southern Africa* (IoDSA).³ The first King Report on Corporate Governance (King I) was published during November 1994. The second King Report on Corporate Governance (King II) was published during March 2002.

King I and II have arguably made a significant contribution towards corporate governance in South Africa. The King Committee has, with King I and II, not specifically dealt with the non-profit organisations. Despite this, some non-profit organisations have endeavoured to make sense out of King II as good corporate governance was increasingly emphasised.

For the overwhelming majority of non-profit organisations in South Africa King I and II have remained largely academic and irrelevant. Efforts were however made to improve the standards of governance for South African non-profits. The Nonprofit Organisations Act (NPO Act) was promulgated in 1998 with the main purpose of encouraging and supporting NPOs in their contribution to meeting the diverse needs of the population of South Africa by creating, amongst other, an environment in which NPOs can flourish. The Directorate for Nonprofit Organisations, which was established in terms of the NPO Act, published the *Codes of Good Practice for South African Non-profit Organisations* during 2001. These Codes were published in an attempt to encourage nonprofit organisations to maintain adequate standards of governance, transparency and accountability and to improve those standards.

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³ http://www.iodsa.co.za/products_reports.asp?CatID=151

In contrast to its predecessors, King III now “*applies to all entities regardless of the manner and form of incorporation or establishment and whether in the public, private sectors or non-profit sectors.*”⁴ This statement includes all non-profit organisations in South Africa. It would accordingly include a crèche formed as legal entity, a community-based sports club, a ratepayers association, a burial society, small scale co-operatives, faith-based organisations and political parties.

King III further states that: “*We have drafted these principles so that every entity can apply them and, in doing so, achieve good governance.*” This paper argues that this last mentioned statement by King III is void of substance and truth. It further argues that some of the principles contained in King III can, on the contrary, have a harmful effect on non-profits. This paper is not borne out of a mistrust or suspicion towards the King committee but a concern with the enabling environment that civil society organisations enjoy and the impact of the King III code and report thereto.

II. WHAT DID THE DRAFT KING III SAY?

We have on a previous occasion⁵ argued that King III is a commercial governance code which has now been imposed on the non-profit sector of South Africa. It is clear that the King Committee had commercial enterprises in mind when they prepared King III. This was patently obvious when the *Draft Code of Governance Principles for South Africa* was published during February 2009. The following remarks were made in the draft Report:

- a. “In the real world, the ultimate compliance officer is not the company’s compliance officer or a bureaucrat ensuring compliance with statutory provisions, but the marketplace.”⁶ [emphasis added]
- b. “Shareholders should approve the company’s remuneration policy.”⁷ [emphasis added]
- c. “The board’s paramount responsibility is the positive performance of the company in creating value for its shareholders. In doing so, it should appropriately take into account the interests of other stakeholders.”⁸ [emphasis added]
- d. “Shareholders are ultimately responsible for the composition of the board and it is in their own interests to ensure that the board is properly constituted.”⁹ [emphasis added]
- e. “Although a company is an economic institution, it remains a corporate citizen and therefore has to balance economic, social and environmental value. The triple bottom line approach enhances the potential of a company to create economic value. It ensures that the economic, social and environmental resources the

⁴ King III Report, p. 17

⁵ Hendricks, PSA and Wyngaard, R.G., (2010) *South Africa’s King III: A Commercial Governance Code Determining Standards of Conduct for Civil Society Organizations*, The International Journal of Not-for-Profit Law, Volume 12, Issue 2

⁶ King Committee on Governance (2009) *Draft Code of Governance Principles for South Africa*, p.18

⁷ Ibid, p.48

⁸ Ibid, p.21

⁹ Ibid, p.36

company requires to remain in business are treated responsibly. By looking beyond immediate financial gain, the company ensures that its reputation, its most significant asset, is protected. There is growing understanding in business that social and environmental issues have financial consequences.”¹⁰ [emphasis added]

A. THE PARAMOUNT RESPONSIBILITY OF THE BOARD

The draft Code stated that: “*We have drafted the principles on the basis that, if they are adhered to, any entity would have practised good governance.*” The very first principle in the draft Code provides that: “*The board should act as the focal point for corporate governance*”

The King Committee then attempted to define what the *paramount responsibility* for the board of *every entity* is, being: *the positive performance of the company in creating value for its shareholders*. This paramount responsibility does not apply to the millions of non-profits operating all over the world because they do not have shareholders. King Committee has subsequently, after having pointed this out, corrected this obvious blunder. It is however a clear illustration that commercial enterprises (not non-profits) were on the minds of the King Committee when they conceived King III.

Our argument is further supported by the contention¹¹ that the word *business* could be found more than 150 times in the draft Report whilst the term *non-profit* only came up four¹² times. This situation has *not* drastically improved in the final Report which remains skewed towards businesses.

The draft Code also related the CEO’s function to role he/she plays in relation to shareholders. It stated that: “*The CEO should ensure that the long-term strategy and vision of the company and its management are developed and recommended to the board to generate satisfactory levels of shareholder value and positive relations with stakeholders.*”¹³ [emphasis added]

III. WHAT IS KING III SAYING NOW?

A. KING III AND THE NEW COMPANIES ACT OF 2008

King III states that, “*The third report on corporate governance in South Africa became necessary because of the new Companies Act no. 71 of 2008 and changes in international governance trends.*” Although King III draws no distinction between for profit and non-profit companies, the Companies Act 71 of 2008 draws a clear distinction between the two forms of companies. Section 8 (1) of the Companies Act provides that, “*Two types of companies may be formed and incorporated under this Act, namely profit companies and non-profit companies.*” The distinction between the two forms of companies is based upon the reason for their existence.

¹⁰ Ibid, p.52

¹¹ Submission prepared by Ricardo Wyngaard and Peter Hendricks for the South African Institute for Advancement during April 2009.

¹² Two in reference to non-profits as *stakeholders* and one in a footnote.

¹³ Paragraph 93 on page 34

A profit company is defined in terms of the Companies Act of 2008 as a *company incorporated for the purpose of financial gain for its shareholders*.¹⁴ This defines the essence of a profit company. A profit company would have no meaningful reason for its existence without financial gain for its shareholders. Despite this, the prominence of shareholders within the governance framework (of profit companies) has been a subject of dispute. For example, King III refers to the *Inclusive stakeholder and enlightened shareholder* approaches in its introduction and affirms its support for the former.¹⁵ This dispute is largely academic of nature for non-profits because profit is not their main objective and they do not have shareholders.

The non-profit company is defined in the Companies Act of 2008 as a company incorporated for a public benefit or other object as required by item 1(1) of Schedule 1.¹⁶ This definition is consistent with that found in the Nonprofit Organisations Act of 1997 which defines a nonprofit organisation as¹⁷ a trust, company or other association of persons established for a public purpose.¹⁸ The implication is that, except for mutual benefit organisations, nonprofit organisations exist for a public purpose (not to profit for its members) and are accordingly accountable to the broader public.

Although the King Committee avers that the Companies Act of 2008 is one of the reasons for King III it has simply ignored the recognition of the nonprofit company within the Companies Act of 2008. In addition, King III has, seemingly, not taken into account that one of the purposes of this Companies Act 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*.

1. King III's First Principle:

The first principle of King III provides that; *"The board should provide effective leadership based on an ethical foundation."* This principle is broad and would certainly find application within the non-profit sector. However, King III's deliberation on this principle illustrates its preoccupation with profit companies. In explaining the significance of this principle, King III states that:

- *Responsible leaders build sustainable businesses by having regard to the company's economic, social and environmental impact on the community in which it operates. [emphasis added]*
- *Responsible leaders reflect on the role of business in society. [emphasis added]*
- *Responsible leaders do business ethically rather than merely being satisfied with legal or regulatory compliance, uncritically aligning with peer standards, or limiting themselves to current social expectations.*

¹⁴ Section 1 of Companies Act of 2008. King III is ostensibly not in agreement with this definition because it states that; *"The primary reason for the existence of business enterprise is to create value. Traditionally, the notion of value was viewed narrowly as financial value for shareholders."* p.30

¹⁵ Page 13 of King III

¹⁶ And the income and property of which are not distributable to its incorporators, members, directors, officers or persons related to any of them except to the extent permitted by item 1(3) of Schedule 1.

¹⁷ Section 1 of the Nonprofit Organisations Act

¹⁸ And the income and property of which are not distributable to its members or office-bearers except as reasonable compensation for services rendered

On page 21 King III further states that, “*Corporate governance models around the world differ on the question to whom the board is responsible.*” In essence, the question is whether the board responsible to the *stakeholder* or *shareholder*. This fundamental question is essentially relevant to *for profit* entities. Nonprofits are inherently accountable to a wide range of stakeholders. It has been pointed out by Robert Lloyd¹⁹ that non-profits are: *upwardly* accountable to their donors (those who provide financial support); *downwardly* to their beneficiaries (those on whose behalf they speak), *inwardly* to themselves and *horizontally* to their peers.

The principles of King III do not stand alone. Every entity that wants to apply the Code effectively should have access to the Report which explains each principle in more detail. The Report is however deeply skewed towards commercial enterprises.

2. Compensating Board Members

The King Committee adjusted the final King III report to take care of obvious errors reflected in the draft Code. Despite this, King III remains fundamentally flawed in its proposed application to the non-profit sector. For example, it is hard to see how King III’s *Principle 2.25* can be applied by non-profits and, in doing so, achieve good governance. This principle provides that; “*Companies should remunerate directors and executives fairly and responsibly.*” In explaining this, King III states that “[*non-executive director*] fees should comprise a base fee which may vary according to factors including the level of expertise of each director, as well as an attendance fee per meeting.” The shareholders must approve these fees in advance. This principle provides, in theory, justification for the payment of directors’ fees, including attendance fees, to non-profit board members.

In the largest study on non-profit governance²⁰ conducted to date in the United States of America, it was found that non-profits “*rarely reported compensating board members – only 2 percent did so.*”²¹ One of the main reasons for this is because non-profit boards generally take responsibility for charitable donations earmarked for public purposes. Donors have more confidence entrusting their charitable donations into the hands of organisations with strong boards that do not have any financial interests in the organisation. The non-profit sector is commonly referred to as the ‘*voluntary sector*’ because board members ordinarily volunteer their time to serve on boards. Contrary to this well established practice in the non-profit sector, King III now recommends that South African non-profits *should remunerate directors*.

¹⁹ Lloyd, R., (2005) *The Role of NGO Self-Regulation in Increasing Stakeholder Accountability*, Oneworld Trust

²⁰ Ostrower, F. (2007) *Non-profit Governance in the United States: Findings on Performance and Accountability from the First National Representative Study*. The Urban Institute. According to the study “*Over 5,100 nonprofit organizations of varied size, type, and location participated in our study, making it the largest sample studied to date.*” p. 1

²¹ The compensation of board members of non-profits is further discouraged by the *Internal Revenue Service* and the *Panel on the Nonprofit Sector*: “*The draft IRS Good Governance Guidelines state that ‘charities should generally not compensate persons for service on the board.’ Recent draft principles issued for comment by the Panel on the Nonprofit Sector convened by Independent Sector note that board members are generally expected to serve without compensation and propose that those who do compensate be able to provide detailed documentation to justify compensation levels and rationale. Nonprofits in our study rarely reported compensating board members—only 2 percent did so.*”p.11

Because non-profit organisations do not have shareholders, *Principle 2.27* of King III stating that, *shareholders should approve the company's remuneration policy*, is also not applicable. King III is effectively giving non-profit boards the freedom to pay themselves for serving on boards and attending meetings. This kind of governance practice in the non-profit sector would bear the risk of eroding donor confidence and would simply be harmful for the non-profit sector.

IV. DANGERS KING III HOLDS TO NON-PROFITS IN SOUTH AFRICA

Before 1994, and still today, non-profit organisations have played and continue to play an important role in the South African Society in combating injustice, addressing the needs of the poor, and, in promoting participation in democracy for those who are often marginalised. This was not always as easy as it is today. Prior to 1994 the state took every opportunity to ensure that these organisations do not live to see another day. Some of the measures employed included; outlawing organisations, preventing and refusing funding to others and applying stringent requirements that would make functioning as an organisation impossible. The environment then was pretty disabling to the formation and development of progressive non-profit organisations.

Since the end of apartheid there has been a dramatic increase in recognising the important role of non-profits, commensurate with this greater effort was also made by the state to ensure that an enabling environment is created conducive for the growth of the non-profit sector. One such very important step was the inclusion of our fundamental rights and freedoms in the Bill of Rights to the South African constitution. Other initiatives were the enactment of the NPO Act, and, the reforms to the Income Tax Act. All these efforts were deliberately and purposefully aimed at creating an enabling environment for the non-profit sector. This enabling environment is characterised by what is known as the Aspen Matrix as presented by *Alan Fowler* in *An Enabling Environment for Civil Society: What does it mean and how does the law fit it*, as captured in the impact assessment as per the table below.²²

²² Department of Social Development (2005) An impact Assessment of the NPO Act, No. 71 of 1997, p.28

Table 7: Aspects and conditions of an enabling environment ¹⁹

Outcome domain	Legal dimensions/conditions
Generic pre-conditions	Constitutional guarantees of civic right Judicial system - autonomy and access
Association	Freedom of association and assembly Maintenance of public order Public benefit recognition/NPO registration
Resource mobilisation	Public benefit/NPO taxation, exemptions and privileges Labour law and regulations Reporting on financial transactions
Voice	Freedom of expression Right of access to public media Public media control and censorship
Information and communication	Private media ownership, control and censorship Freedom of access to public information Control on citizen movement and residence
Negotiation	Political processes - elections, referendums Participation in public policy making NPO participation in (local) governance system Corporate standards and compliance system

The question that needs to be asked is: *how much did the King Committee consider the impact of King III on the enabling environment for non-profits?* King III clearly presents a number of dangers to the enabling environment for the non-profit sector, including:

- a. *Directing the course of CSI funding* – Commercial enterprises would in all probability require the beneficiaries of their CSI Programmes to apply the principles of King III in order for non-profits to qualify for funding. CSI has grown significantly in South Africa. “*Dialogue estimates that the total expenditure on corporate social investment in South Africa for the 2007/8 financial year amounted to R4.1billion. In nominal terms, this figure is 29% higher than the R3.2 billion for the 2007/07 financial year,*”²³ In the event that commercial enterprises require compliance with King III as criteria for CSI funding, community-based organisations will find it hard to access such CSI funding.
- b. *Further alienation of community-based organisations* – The effective implementation of the King III Code is based upon governing boards also having access to the King III Report. The Code and its practice notes can be downloaded free of charge from the website of the *Institute of Directors Southern Africa* (IOD). The Report, which explains much of the content of the principles contained in the Code, can be bought at R600-00 from the IOD or read online in *iPaper* format. In 2001 it was estimated that 53 929²⁴ informal/voluntary organisations were operating in South Africa. The actual number of voluntary associations that are registered with the Directorate for Nonprofit Organisations during 2009 was 53051.²⁵ These organisations play an important role in poverty alleviation and the building of sustainable communities. It is questionable whether most of these organisations would be in a position to buy the King III report from the IOD as

²³ 11th Edition CSI Handbook – published by Dialogue

²⁴ Swilling, M. and Russell, B. (2002) *The Size and Scope of the Non-Profit Sector in South Africa*, School for Public and Development Management, University of the Witwatersrand, p.21

²⁵ Department of Social Development (2009) *The State of NPO registration in South Africa, "A Report from the National NPO Database"*, p. 10. (Numbers as at March 2009)

they mostly operate with limited financial resources. An Impact Assessment study²⁶ of the Nonprofit Organisations Act concluded, amongst other, that:

- Overall, NPOs receive the bulk of their funding from local sources, namely government and the private sector.
- Corporate social investment budgets are predominantly (66%) spent in urban areas.
- Government funding, the bulk of which is in social services, health and housing, tends to go to well organised, formal NPOs.
- International private foundations predominantly fund larger, more sophisticated NGOs that are often urban based.

It is likely that King III, with its commercial undercurrent, would further alienate community-based organisations from receiving donor support. This is because organisations that can afford to buy a copy of the King III report and comply with it, would be more attractive to donors.

- c. *Overburdening organisations* – King III would overburden the non-profit sector with requirements that are predominantly relevant for commercial enterprises. For example, Principle 3.1 provides that: “The board should ensure that the company has an effective and independent audit committee.” Principle 3.1 provides that: “Audit committee members should be suitably skilled and experienced independent non-executive directors.” This committee should consist of at least 3 members who collectively have an understanding of: integrated reporting, internal financial controls, corporate law, risk management, information technology governance and sustainability issues. King III recommends that the audit committee must also report to the shareholders at the AGM. These principles have been introduced by King III, despite the fact that audit reports are not an absolute requirement in terms of the Companies Act of 2008. It is hard to conceive how smaller community-based organisations operating within impoverished communities across South Africa can apply these two principles. In addition to concerns of being pre-occupied with implementing these, the overall detailed prescriptions of the recommended practices ask for the adoption of rigid managerial practices that are not suitable for quick and adaptable responsiveness that the non-profit sector requires. King III places an undue burden on most non-profit organisations in South Africa.
- d. *Mission drifting* – King III poses the risk of causing non-profits to focus more on business activities and potentially drifting from their social missions.²⁷ As pointed out above, the private sector is primarily focused on financial gain for its shareholders. The private sector ideology is focused on making profit for private gain. Non-profits are increasingly being pressured to adopt the same market-based practices as commercial enterprises. King III is effectively proposing a business model for all entities which may ultimately have the effect of causing non-profits to focus more on market-place strategies and thereby abandoning their public benefit focus.

²⁶ Department of Social Development (2005) An impact Assessment of the NPO Act, No. 71 of 1997, p.45

²⁷ The authors of the following article argue that this kind of development causes increased instability in the non-profit sector. Evans, B., Richmond, T. and Shields, J. (2005) *Structuring Neoliberal Governance: The Non-profit Sector, Emerging New Modes of Control and the Marketisation of Service Delivery*, “The neoliberal model of market-based regulation has moved many nonprofit service organisations away from their community-oriented focus and towards a ‘business model’”.

- e. *Eroding democracy* – Research has shown that community-based organisations play an essential role in safeguarding democracy.²⁸ It is clear that the King Committee has not taken the community-based sector into account in developing King III. Communities, in terms of King III, are deemed ‘stakeholders’. To this extent, *the board should appreciate that stakeholders’ perceptions affect a company’s reputation.*²⁹ The relevance of the stakeholders is dependent on whether or not they promote the best interests of the company. The role of community-based organisations in building vibrant and sustainable communities is accordingly lost in the market-place ideology of King III. These community-based organisations are now required to apply a commercial governance code or, if not, explain why they have not applied King III.
- f. *Development of commercial-based legislation* – King III states that “*Good governance is not something that exists separate from the law and it is inappropriate to unhinge governance from the law.*”³⁰ King III further states that *corporate governance practices, codes and guidelines therefore lift the bar of what are regarded as appropriate standards of conduct. Consequently, any failure to meet a recognised standard of governance, albeit not legislated, may render a board or individual director liable at law.*³¹ This means that, contrary to the recognition of non-profits in the Companies Act of 2008, King III may eventually have the result of also introducing commercial-based governance standards for non-profits into legislation.

V. WHAT ARE THE OPTIONS FOR NPOs?

South Africa’s CSO sector are also hugely diverse, which diversity can be attributed to many factors such as; historic development, geographic location, origin, challenges, objectives, size, means of obtaining financial and other resources, etc. The impact of these factors should not be ignored when it comes to the structures adopted and governance models applied by these diverse organisations.

One-hundred and twenty-three people were involved with the compilation of King III and less than 20% of them were serving as directors at that time.³² It is assumed those serving as directors were serving on the boards of commercial companies. It is questionable whether they understood the issues that are important to the governance of non-profit organisations. The IoD considers itself *The Business Leaders*.

Presently, the options that civil society is faced with are; *one*, apply the King III code unreservedly (of which there is no doubt a handful would be able to), *two*, adapt the King III Code to its needs (and face the risks highlighted above), or, *three*, develop a completely separate governance code more suited to the South African non-profit sector that would add to the enabling environment.

If our focus is the enabling environment for the entire sector the most obvious logical conclusion is a separate enabling governance code, especially if we consider the words of Jim Collins when he remarked that

²⁸ Putnam, R. (1993) *Making Democracy Work: Civic Traditions in Modern Italy*.

²⁹ Principle 8.1

³⁰ The King Committee, (2009) *King Report on Governance for South Africa*, Institute of Directors

³¹ *Ibid*

³² *Ibid*, p.6

We must reject the idea, well intentioned but dead wrong, that the primary path of greatness for the social sector is to become more like a business. Most businesses like most of anything else in life fall between mediocre and good. Few are great. When you compare great companies to good ones many widely practiced business norms turn out to correlate with mediocrity not greatness. So why do we want to import the practices of mediocrity into the social sector?³³

Success in the non-profit sector is not defined by the financial viability of the entity (with well balanced and responsible business practices that has regard to people, profit and planet.) It is the sustainability of the cause in addressing the needs of people and the planet. Unlike as proposed by King III, that stakeholders need to be considered in the governance processes, the overwhelming majority of non-profit organisation has as a central part of their bottom line the interest of their stakeholders well structured according to priority, which priority is closely aligned with its mission.

Whereas the King III looks, amongst other themes, at ethical standards and stakeholder relations, non-profit organisations reach deeper and look at community inclusiveness, member rights, democratic processes, volunteer involvement and retention, and, representation.

Given these, non-profits cannot afford to look to business models as the standard for governance practices, especially in the South African context. This context demands that any effort to develop a governance code enabling of the non-profit sector must not merely be based on best practices of standards of financial, legal and managerial accountability. It should, amongst other, also be based on the following factors:

- 1 It has to be done inclusively given the diversity of the non-profit sector to ensure that there is representative,
- 2 The processes leading up to the development of the final code should be conducted commensurate with the value of democracy,
- 3 The end product itself should reflect representivity and democracy, and
- 4 Encourage volunteerism.

Universally the non-profit sector is very responsive, highly diverse and fiercely independent. Setting standards has to be done giving special attention to the fragile environment it operates in and the history that has shaped the present. Four principles underscore the approach required to develop a governance code:

- 1 The code has to develop and evolve from within the sector and not externally imposed;
- 2 The process cannot be rushed. It must development gradually and evolutionary;
- 3 The methods employed must be consultative and consensual; and
- 4 It must not only be standards of measurement but also be able to empower organisations.

The impact of the system of apartheid on enabling non-profit governance is underestimated. The business sector had centuries to grow and develop their governance practices to now culminate into a code. The South African civil society was only afforded this opportunity, to

³³ Mp3 file entitled "The solution is not to be more like a business." Downloadable from http://www.jimcollins.com/media_topics/social-sectors.html

make a concerted effort to develop governance standards unique to its context, since the demise of the apartheid government 16 years ago. We cannot afford to have our hard-won enabling environment discarded because of a commercial governance code overwhelmingly set to benefit enterprises whose main thrust is competition, often to the fatal detriment of its competitors.

At this vulnerable stage of its development the sector does not need a system of checks and balances and prescriptions to that effect. The only value that King III holds for the South African civil sector is perhaps that it highlights the urgency for work to commence on the development of a separate governance code.

VI. CONCLUSION

The King Committee has, contrary to their stakeholder-inclusive philosophy, not meaningfully engaged with the South African non-profit sector in the development of their commercial governance code. As we have stated earlier, CSO accountability should be promoted through laws and codes. Our intention is not to argue for lesser standards of governance and accountability of CSOs, but for suitable standards. Governance standards should not be introduced on the assumption that marketplace standards are suitable for CSOs.³⁴

It is a gross oversight if non-profit organisations, representing the entire civil society spectrum are not involved in the development of an enabling governance code for the benefit of the sector. A code developed under such circumstances should be approached with reservation and scepticism. It appears that the South African non-profit sector is at a crucial juncture. Each of the options proposed in this paper would have consequences for the non-profit sector – more importantly for the beneficiaries of non-profit organisations.

VII. ABOUT THE AUTHORS

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³⁴ Hendricks, PSA and Wyngaard, R.G., (2010) *South Africa's King III: A Commercial Governance Code Determining Standards of Conduct for Civil Society Organizations*, The International Journal of Not-for-Profit Law, Volume 12, Issue 2