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Bolder than ever

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Introduction

The King Committee published the King IV Report on Corporate Governance for South Africa 2016 (King IV) on 1 November 2016. King IV is effective in respect of financial years commencing on or after 1 April 2017. King IV replaces King III in its entirety.

While we acknowledge that most organisations suffer from regulation fatigue, we welcome this new version of the King Code as it not only provides a more practical, principles-based approach to good corporate governance, but also incorporates both global public sentiment and international regulatory change since King III was issued in 2009.

In our view, King IV is bolder than ever before. Firstly, the Code is principles-based and follows an outcomes– rather than rules-based approach. This is in line with current international sentiment which promotes greater accountability and transparency and speaks to the expressed view that the application of the Code should contribute to the performance and health (sustainability) of the organisation. In this regard it is clear that King IV aims to establish a balance between conformance and performance. The Code is further bold in its relentless effort to reinforce corporate governance as a holistic set of arrangements that concerns itself with ethical leadership, attitude, mindset and behaviour. This echoes global developments in the conduct risk arena and also seeks to address and prevent recent examples of corporate failure. Lastly, the boldness of the Code is evident in the clear focus on transparency and targeted disclosures in all areas, specifically in the introduction of far more extensive executive remuneration disclosure than ever seen before. We believe that the recommendations are in line with global developments and perhaps more relevant than ever before in a country where the income differential remains higher than desired.

In this document we specifically cover our assessment of the impact of the proposals around ethical leadership.

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King IV *and the* governance of ethics

Good corporate governance is essentially about effective ethical leadership. While leadership starts with each individual director, it finds its expression through the Board as a collective, setting the appropriate example and tone which is referred to as ethical governance. King IV explains the governance of ethics as the role of the Board in ensuring that the ethical culture within the organisation is aligned to the tone set by the Board through the implementation of appropriate policies and practices.

The notion of governance of ethics is not new and was covered in King III which stated that ethics is the foundation of, and reason for, corporate governance. King III further included principles around providing ethical leadership and overseeing that the organisation's ethics are managed effectively.

While the requirement in King IV of the Board is to set the tone of leading by example, by being ethical and effective, and to ensure that the organisation's ethics is managed effectively, is broadly similar to King III, King IV specifically introduces the need for the Board to oversee that ethics is monitored and assessed for whether it is successful in establishing ethical norms, and to make the required public disclosures in this regard. It also asks of the Board to oversee that there is consequence management for non-adherence to or contraventions of ethics standards and proposes disclosure of effective ethics management and the outcomes thereof. Specifically, King IV requires that the Board ensures that the relevant codes of conduct and policies are incorporated (by reference or otherwise) in supply and employee contracts. In essence, this should result in a situation where all employees and suppliers agree contractually to adhere to the ethics and values of the company.

While the letter of the word in terms of requirement differs only slightly between King III and IV, the notion of the outcomes- versus rules-based application of the Code should greatly improve the impact of the increased focus on an ethical culture. Regulators around the world are carefully considering the limited effectiveness of rules and regulations to address cultural matters. We therefore welcome the emphasis on an ethical culture as well as the outcomes-based lens used to assess its effectiveness.

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Embedding *an* ethical culture

King IV explains that ethical leadership is exemplified by integrity, competence, responsibility, accountability, fairness and transparency. It involves the anticipation and prevention, or otherwise amelioration, of the negative consequences of the organisation's activities and outputs on the economy, society and the environment and the capitals that it used and affects.

While typically corporate culture is described as a "soft" matter, it is most often the hardest to implement due to the fact that there is no box to tick to conclude that an end goal has been reached. The "what" and the "how" begins in the boardroom. Substantive engagement and oversight is required and a mere process focus will not be good enough. King IV is clear in its expectation that the Board cannot simply set the standard, but must also monitor progress.

A major sustained improvement in culture can be achieved by focusing on values and conduct that are the building blocks of culture. Focusing on values and conduct is a more practical approach, since these are observable and measurable, and can be specified in policies and linked to incentive structures. When an ethical culture is properly understood and well embedded, desired corporate values and conduct should be reflected in the daily habits and practices of employees – how they work, how they are evaluated, who is hired, promoted rewarded, how employees act when managers are not present and when matters of personal judgement arise, and whom the company does business with. When broken down to this level, monitoring becomes easier. The social and ethics committee will in all likelihood be tasked to monitor ethics management and the extent to which the executive (individually and collectively) complies with the ethics key performance indicators (KPIs). Since King IV now proposes that companies establish a clear link between performance and remuneration, it will be necessary for the remuneration committee to consult with the social and ethics committee when a determination is made on the fairness and reasonableness of executive remuneration.

King IV specifically requires Boards to disclose the effectiveness of ethics management and the outcomes thereof. In order to apply this recommendation, Boards will have to set clear, measurable objectives and monitor the successful (or not) implementation thereof. It goes without saying that this is not easily achievable, and Boards will have to carefully apply their minds to creating clear objectives, establish a common understanding of these objectives throughout the business and establish clear KPIs for management to ensure effective implementation. To some extent, each company will have to create its own 'ethics language' to ensure that the values and culture of the business is appreciated and understood at all levels. The disclosure requirements in King IV may seem light at first glance, but on closer inspection it is clear that proper, effective disclosure will require extensive effort – much effort is required to embed the ethics, value and culture throughout the business, monitor success and disclose the results to stakeholders.

Of course, the King IV disclosure requirement also means that the Board remains accountable to stakeholders, and this level of transparency will enable stakeholders to hold the Board to account also with respect to the company's performance on embedding values, ethics and culture.

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International trends

Internationally the move to transparent ethical leadership is well supported. In particular the financial services industry is publicly committing to making improvements in culture as it goes hand in hand with restoring public trust. Yet, at a pan-European level, there is a general lack of ethical language in corporate governance provisions, with Belgium and the United Kingdom being the exception having limited requirements.

A recent publication "Banking Conduct and Culture – A Call for Sustained and Comprehensive Reform" published by the Group of Thirty provides actionable advice to Boards that we believe is applicable across industry, cultural and geographical boundaries.

Despite the lack of formal requirement, there is global acceptance that an undue short-term focus does not only impair capital allocation for the longer term, but impacts the focus on embedding a sustainable culture. This leads to bad behaviour, wilful blindness, and tolerance of lapses that should be dealt with more harshly. It also covers up rather than deals with matters that impair the accepted values of the organisation. It is widely accepted that business is much more vulnerable to reputational damage than ever before – digitisation is positive in getting boardrooms to focus on this vulnerability.

Questions for directors to ask

- Are the Board and Senior Management adequately focused on understanding the culture that exists and seeing adherence to organisational values and conduct as a strategic imperative? Is this evidenced in practices such as transparency for material transgressions, and owning the responsibility for identifying and dealing with problems?
- Does the Board focus adequately on embedding values and conduct by devoting adequate time to these issues, receiving regular comprehensive reporting on these issues and participating in internal communication about the desired behaviours?
- Do the CEO and executive team objectives include conduct, values and cultural matters?
- Does the CEO and executive team incentive regime have material financial consequences for managers whose oversight of desired values and conduct is weak?
- Do the organisation's promotion and hiring processes place material weight on compatibility with the desired values?
- Do the organisation's supply chain and outsource relationships consider and reflect the desired values and behaviours?
- Does the Board consider the ethical business culture of suppliers, clients and customers to ensure an ethical supply chain?
- Is there evidence of a culture of welcoming escalation or self-identification of issues, including the expectation of such conduct, and are there sanctions for wilful blindness?
- Is the Board able to disclose the effectiveness of ethics management and the outcomes thereof?

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Conclusion

All business operates with an implicit social licence to do so, and the speed of and access to information as well as the legislated level of corporate transparency make it hard to maintain that social licence. It is fair to say that many leaders are already engaged in the important endeavour of embedding an ethical culture which is commendable as it is a prerequisite for sustainable economic returns, and – in the medium-term – a source of competitive advantage.

To conclude: Wise leaders understand that culture eats strategy for breakfast. We believe it is right that King IV has re-emphasised ethical leadership and the need for Boards to take an interest in embedding ethical culture in the organisations they govern. It is important that Boards recognise that oversight over the “softer” matters is often the hardest to execute.

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