THE KING REPORT ON CORPORATE GOVERNANCE

1. WHY IS KING IV NECESSARY?

Some people did not welcome the news that the Institute of Directors in Southern Africa had initiated an update of the King Report on Governance for South Africa (2009) (King III). For them, it simply meant an additional compliance burden.

In addition to the fact that the update offers a chance to take into account developments in corporate governance globally, the update has also been used to reposition corporate governance as a source of value to organisations, and not just a set of regulations with which they have to comply.

Corporate governance repositioned as a value-add

No South African should need persuading that a lack of corporate governance underpins virtually all of the various ills that are imperilling our democracy and the welfare of society. Municipalities struggle to meet citizens' demands for service delivery because of corruption or incompetence; important public sector institutions are rendered dysfunctional by the appointment of unsuitable officials; and some parastatals are deemed to have become vehicles for enrichment. Similarly, in the private sector, claims of collusive and anti-competitive behaviour surface regularly, and controversy rages over the quantum of executive pay and the wage gap.

Corporate governance, mindfully applied, is a fundamental part of the solution to these and other challenges. The key words here are "mindfully applied", and this is where King IV hopes to make the most impact by linking governance more tightly to value creation and the achievement of desired outcomes.

Corporate governance for all

Corporate governance is an ecosystem made up of public companies, SMEs, non-profit organisations, and institutional investors such as retirement funds and public sector entities. All of these types of organisation affect the governance of one another in the bigger ecosystem. The King Committee therefore designed King IV to make it more accessible for users across this eco-system by:

- Using a vocabulary that indicates the Report's applicability to all organisations. Thus, King IV talks about "organisations" rather "businesses" or "companies", "governing bodies" rather than "boards", and "those charged with governance duties" rather than "directors".
- Providing supplements to help organisations across a variety of sectors and organisational types to interpret and implement King IV to suit their particular circumstances.
- Providing guidance on how to scale the recommended practices in accordance proportionally, in line with the organisation's size and resources, and the extent and complexity of its activities.

2. HOW DOES KING IV GO ABOUT INSTILLING MINDFUL APPLICATION?

King IV follows an outcomes-based approach. This approach is evident from the structural building blocks of the
King IV Code, namely governance outcomes, principles and practices.

Governance outcomes: Corporate governance is not presented as an end in itself, but rather a means towards realising certain benefits, or governance outcomes: ethical culture, good performance, effective control and legitimacy. In essence, King IV promotes the view that achieving the aspirations as expressed in the principles optimises organisations to realise the governance outcomes.

Principles: The principles are an expression of the fundamental aspirations of any organisation wishing to achieve good corporate governance. Examples of principles within King IV are: "The governing body should lead ethically and effectively"; "The governing body should govern risk in a way that supports the organisation in setting and achieving its strategic objectives"; and "The governing body should ensure that the organisation remunerates fairly, responsibly and transparently so as to promote the achievement of strategic objectives and positive outcomes in the short, medium and long term." As should be evident from these examples, once an organisation professes to adopt good governance, it is very hard to argue why the norms as established by the principles should not be upheld.

The principles are therefore seen as fundamental and basic to good governance.

Practices: Organisations should implement the practices in order to support the achievement of the principles, and thus of certain governance outcomes. However, organisations are allowed greater freedom to exercise their judgement about whether to apply the recommended practices and how to do so, provided their overall aim is to achieve the aspiration expressed in the principle. In this sense, the principles represent the target for which the practices are aiming.

Apply and explain regime: In accordance with the outcomes-based approach, King IV emphasises the disclosure not of what practices have been implemented, but rather the impact or effect of those practices. To balance the less prescriptive approach adopted in King IV, it emphasises greater transparency with regards to how organisations exercise their judgement. King IV seeks to reinforce this qualitative application of its principles and practices, by proposing an "apply and explain" approach to compliance, in contrast to the "apply or explain" advocated in King III.

3. THE KING IV REPORT AND ITS PARTS

The King IV Report consists of seven parts:

Part1: GlossaryofTerms. This was placed upfront as an understanding of the meaning of terms used in King IV is essential for its application.

Part2: FundamentalConcepts. This part contains the fundamental concepts and philosophy on which King IV is based, the distinguishing features of King IV, and how the various developments in corporate governance locally and internationally since King III came into effect in 2009 have influenced the principles and practices in the Code.

Part3: KingIVApplicationandDisclosure. This explains the application regime of King IV, and where and how King IV disclosures need to be made.

Part4: KingIVonaPage. This part constitutes an executive summary of King IV and demonstrates how all the parts form an integrated whole.

Part5: KingIVCodeonCorporateGovernance. Part 5 is the heart of the King IV Report, and consists of the governance outcomes, principles and practices.

Part6: SectorSupplements. Sector supplements are provided for municipalities, small and medium-sized enterprises (SMEs), state-owned enterprises (SOEs), non-profit organisations (NPOs) and retirement funds.

Part 7: Content Development Process and King Committee

4. DIFFERENCES BETWEEN KING III AND KING IV

King IV's principles and practices do not differ substantially from King III; the main difference between the two lies in King IV's approach. Specific points to notice include:

- King III addressed boards and companies while King IV addresses governing bodies and organisations generally so as to be more inclusive.
- Structurally, the King IV Code is built on practices implemented to support principles which lead towards governance outcomes. In King III, this differentiation between practices, principles and outcomes is not so distinct.
- The application regime of King III was "apply or explain" whereas for King IV it is "apply and explain".
- King IV addresses how to apply practices proportionally, something that King III only implied.
- King IV includes supplements to assist various types of organisation to implement King IV. These organisations are municipalities, SMEs, SOEs, NPOs and retirement funds.

5. HOW KING IV WAS DEVELOPED

The process for developing King IV was designed to build on the strengths of King III. A primary consideration was to involve as many stakeholders as possible; consequently, the King IV drafting process was widely consultative, and followed a participative and inclusive approach.

The drafting of King IV was led by the King IV Project Lead, Ansie Ramalho. The King Committee appointed a task team drawn from its membership to assist her, and oversee the drafting process. The King Committee itself provided final approval.

See part 7 of the Report for the membership of the task team and the King Committee.

6. KING IV HIGHLIGHTS

6.1 Defining corporate governance as the exercise of ethical and effective leadership by the governing body

To move from tick-box compliance to genuine application of corporate governance, ethics have a critical foundational role to play. Only an ethical organisation made up of ethical individuals will act responsibly and fairly, even when nobody is looking. King IV understands corporate governance as a leadership issue; thus creating an ethical organisation depends on leadership that is both ethical and effective.

Ethical leadership is exemplified by integrity, competence, responsibility, accountability, fairness and transparency (ICRAFT). It involves anticipating and preventing, or at least ameliorating, the negative consequences of the organisation's activities and outputs on the economy, society and the environment, as well as on the capitals[1] that it uses and affects. Effective leadership is results-driven, but goes beyond an internal focus on effective and efficient execution. Ethical and effective leadership go hand in hand, the one reinforcing the other.

King IV devotes Part 5.1 of the Code to ethics. It has three main sections. The first covers how the governing body sets an example by displaying the ICRAFT characteristics. In the second, the Code shows how the governing body ensures that the ethics within the organisation is managed. Finally, it makes recommendations for how the organisation acts as a responsible corporate citizen in the way in which it engages with internal and external stakeholders, and society as a whole.

The King IV principles that express the ideas as detailed above are:

Principle 1: The governing body should lead ethically and effectively.
Principle 2: The governing body should govern the ethics of the organisation in a way that supports the establishment of an ethical culture.
Principle 3: The governing body should ensure that the organisation is, and is seen to be, a responsible corporate citizen.

6.2 Integrated thinking

King IV advocates integrated thinking, based on the recognition that organisations do not exist within a vacuum, but rather within a complex web of interdependencies that affect its ability to create value over time. Integrated thinking underpins all of the following concepts:

- The organisation is an integral part of society and thus a corporate citizen;
- Stakeholder-inclusivity;
- Sustainable development; and
- Integrated thinking.

The above concepts are supported by the following principles in King IV:

Principle 3: The governing body should ensure that the organisation is and is seen to be a responsible corporate citizen.

Principle 4: The governing body should appreciate that the organisation's core purpose, its risks and opportunities, strategy, business model, performance and sustainable development are all inseparable elements of the value creation process.

Principle 5: The governing body should ensure that reports issued by the organisation enable stakeholders to make informed assessments of the organisation's performance, and its short-, medium- and long-term prospects.

Principle 6: In the execution of its governance role and responsibilities, the governing body should adopt a stakeholder-inclusive approach that balances the needs, interests and expectations of material stakeholders in the best interests of the organisation over time.

6.3 Balanced composition of governing bodies and independence

Principle 7, "The governing body should comprise the appropriate balance of knowledge, skills, experience, diversity and independence for it to discharge its governance roles and responsibilities objectively and effectively", expresses the aspiration for the balanced composition of the governing body.

Having members of the governing body who are independent in appearance is an essential element in most governance codes. Academic research since the global financial crisis has however shown that, despite all of the financial institutions involved having had the prescribed number of independent directors, and more in some instances, they still failed.

Hence, it is an aim of King IV to contextualise the relevance of independence correctly. Two important points should be borne in mind:

- All members of the governing body, whether executive, non-executive or independent non-executive, have a legal duty to act with independence of mind in the best interests of the organisation.
- Although important, independence is only one of the factors to be considered in achieving balance in the composition of the governing body.

The overriding concern is whether the governing body is knowledgeable, skilled, experienced, diverse and independent enough to discharge fully its governance role and responsibilities.

The need for the governing body to set and disclose progress on targets for race and gender diversity has specifically been included in the Code in order to help achieve this balance.

6.4 Social and Ethics Committees

Principle 8, "the governing body should ensure that its arrangements for delegation within its own structures promote independent judgement and assist with balance of power and the effective discharge of its duties" addresses the establishment of committees by the governing body". The King IV Code recommends that committees for audit, nominations, risk remuneration and social and ethics be considered.

The new Companies Act[2] was issued after King III. Regulation 43 stipulates the formation of a social and ethics committee but, outside of the committee's name, does not address its ethics role. King IV seeks to expand on this by recommending that the social and ethics committee should be responsible for overseeing and reporting on organisational ethics, responsible corporate citizenship, sustainable development and stakeholder relationships.

While these responsibilities include organisational ethics and cover the statutory duties outlined in the Companies Act, the intent is to encourage leading practice by having the social and ethics committee progress beyond mere compliance to contribute to creating value. Accordingly, King IV urges organisations that are not legally required to establish a social and ethics committee, nevertheless to consider creating a structure that would achieve these aims.

King IV also recommends a higher standard for the composition of this committee than provided for in the Companies Act. Thus, it recommends that a majority of the members should be non-executive members of the governing body so as to bring independent judgement to bear on the matters that the social and ethics committee is responsible for.

6.5 Risk and opportunity

King IV's definition of risk consists of three parts, namely *uncertainty*; the *likelihood* of such uncertainty occurring; and the *effects*, positive and negative, of such occurrence.

King IV's understanding of risk thus balances the traditional, negative view of risk with one that recognises the potential opportunities inherent in some risks. Thus, an opportunity may present itself as the potential upside of a risk, even though that risk could adversely affect the achievement of organisational objectives.

However, King IV also recognises that not all opportunities originate from the current risks of the organisation. This is particularly true of the strategic opportunities that should be considered when setting the organisation's strategic direction. Consideration of the risks associated with such strategic opportunities affect whether the opportunity will be captured by the organisation or not.

Risk is becoming more complex, requiring risk oversight to be strengthened. Accordingly King IV recommends that the risk committee comprises a majority of non-executive members. This recommendation goes beyond what was required in King III.

Risk governance should aim for what is stated as follows in **Principle 11**, "The governing body should govern risk in a way that supports the organisation in setting and achieving its strategic objectives".

6.6 Technology and information

Principle 12 provides that "The governing body should govern technology and information in a way that supports the organisation setting and achieving its strategic objectives". King IV takes cognisance of the advances in technology that are revolutionising businesses and societies, and transforming products, services and business models. So profound are these effects that many believe they herald the dawn of a Fourth Industrial Revolution.

These advances happen quickly and can cause significant disruption. In line with King IV's assertion that risk often creates opportunity, organisations should strengthen the processes that help them anticipate change and respond by capturing new opportunities and managing emerging risks. The practices under Principle 12 are designed to assist the governing body to do so.

Information, like technology, is a growing source of competitive advantage for the enhancement of the intellectual capital of an organisation, and for serving its customers more effectively.

King IV recognises that information and technology overlap but are also distinct sources of value creation, each of which has its own risks and opportunities. To reinforce this distinction, this section in the King IV Code now refers to information and technology instead of information technology.

6.7 Remuneration

Remuneration has become a burning topic, and many international regulators and institutional investors are paying additional attention to disclosure and voting on remuneration. King IV had to consider the appropriate means of dealing with these developments, taking into account that South Africa is a participant in the global investment market but with its own unique set of circumstances. The approach is set out in **Principle 14**, which provides that “The governing body should ensure that the organisation remunerates fairly, responsibly and transparently so as to promote the achievement of strategic objectives and positive outcomes in the short, medium and long term”.

This is how remuneration was addressed in the practices:

Disclosure
King IV aims to foster enhanced accountability on remuneration. It therefore includes more definitive disclosure requirements, one being that remuneration should be disclosed in three parts: a background statement, an overview of the remuneration policy, and an implementation report.

Voting
King IV recommends that shareholders of companies be provided the opportunity to pass separate, non-binding advisory votes on the remuneration policy and the implementation report. The remuneration policy should record the measures that the board commits to in the event that 25% or more of the voting rights exercised by shareholders are exercised against either the remuneration policy or the implementation report, or both. King IV recommends that such measures should include engagement with the parties so exercising their votes, and addressing their objections and concerns.

South Africa is the only country in which the threshold for these remedial measures is as low as 25%; in Australia, the United Kingdom and Belgium, among others, remedial measures are only mandated if 50% or more of the votes are cast against the remuneration policy and/ or implementation report. Internationally, the vote is binding in very limited instances; for example, in the UK, on the adoption of the remuneration policy. In all other instances, provision is made for a non-binding advisory vote, for example on implementation (United Kingdom) and on adoption of the implementation report (Australia).

Broader performance measures
King IV furthermore recommends the use of performance measures that support positive outcomes across the triple context[3] in which the organisation operates, and/or all the capitals that the organisation uses or affects. In other words, remuneration is no longer linked solely to financial performance.

In respect of executive remuneration, King IV recommends that organisations disclose what performance measures and targets were used in order to award variable remuneration.

Wage gap
Importantly, King IV introduces practices related to the wage gap between executives and those at the lower end of the pay scale. It recommends that the remuneration of executive management should be fair and responsible in the context of overall employee remuneration, and further how the governing body addresses this issue.

6.8 Assurance and internal audit

Principle 15 states that “The governing body should ensure that assurance services and functions enable an effective control environment, and that these support the integrity of information for internal decision-making and of the organisation’s external reports”.

King III introduced the combined assurance model by stating that the "combined assurance model aims to optimise the assurance coverage obtained from management, internal assurance providers and external assurance providers on risk areas". This concept needed to evolve to become more useful and effective. King IV therefore addresses the meaning of assurance for the purposes of the combined assurance model, it expands on who the assurance service providers and functions consist of, the users of the model and its objectives. King IV assumes an understanding of assurance that goes beyond mere technical definitions. The combined assurance model as envisaged in King IV seeks to incorporate and optimise all assurance services and functions so that, taken as a whole, these enable an effective control environment and also support the integrity of information used for internal decision-making by management and the governing body, and of external reports.

The King IV Code's recommendations do not prescribe the design of the model, allowing the governing body to exercise its discretion in this regard.

Internal audit, as one of the assurance providers to the organisation, remains pivotal to corporate governance. In recent years, it has evolved to become a trusted advisor that adds value by contributing insight into the activities of the organisation and, as a further enhancement, foresight. For King IV, this is the ideal positioning for audit.

6.9 Auditor and audit requirements

Mandatory rotation of audit firms, and mandatory tendering, have been introduced in some jurisdictions to reinforce auditor independence and audit quality. King IV leaves this decision to the audit committee and governing body, subject to legislative requirements. The Code, however, makes certain practice recommendations in support of auditor independence, amongst them that the tenure of an audit firm needs to be disclosed.

Following the UK Corporate Governance Code[4] and in the interests of more informative reporting on the auditing process, King IV recommends that the audit committee discloses significant matters it considered in relation to the annual financial statements, and how these matters were addressed by the committee. This provides users of the financial statements with three different perspectives on the annual financial statements:
The governing body's description of how the annual statements were prepared, and particularly its significant assumptions.

- The auditor's explanation of what areas were considered to be most significant, and how they were addressed in the audit.
- The audit committee's disclosure of what matters it regarded as significant, and how it discharged its responsibilities in relation to these matters.

King IV also recommends that the audit committee discloses its views on audit quality with reference to audit- quality indicators.

6.10 Tax

Tax has become a complex matter with various dimensions. It has become apparent from recent events especially in the United Kingdom, involving Starbucks, Amazon and Google, that payment of taxes has become a reputational issue.

The governing body should be responsible for a tax policy that complies with the applicable laws, but that is also congruent with responsible corporate citizenship, and that takes account of reputational repercussions. Hence, responsible and transparent tax policy is put forward as a factor in good corporate citizenship in King IV and dealt with under **Principle 3** referred to above.

[3] See Part 1 of the King IV Report for a definition.

[4] The Financial Reporting Council Limited; UK Code on Corporate Governance, (April 2016), p 19

[5] Freshfields Bruckhaus Deringer; "A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment", *UNEP Finance Initiative*, 2005, p 13 available at www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf.

[6] Pension Funds Act 1956 24 of 1956, available at www.saflii.org.za.

6.11 Shareholder activism

When it comes to the quality of an organisation's application of voluntary codes of governance, it is said that its stakeholders are the ultimate compliance officers. Shareholders, as a particular stakeholder sub-set, have certain rights that are enshrined in company legislation and that strengthen their ability to hold boards of companies to account. By virtue of this ability, shareholders can act as proxies for wider stakeholder interests.

While shareholders have rights and wield influence, it should be remembered that they have no legal or fiduciary responsibilities to the companies in which they invest. Furthermore, shareholders are not committed to the company for any specific length of time, and yet have the right to vote on matters whose impact will continue to be felt long after they have disinvested from the company.

Institutional investors, in particular, are an extremely influential shareholder sub-set. The types of investment decisions they make, and how they exercise their rights as shareholders, either reinforce or weaken good governance in the companies in which they invest.

Institutional investors owe their fiduciary duty to members of retirement funds, their dependants and beneficiaries. This fiduciary duty has certain consequences for how institutional investors should exercise their rights in other companies.

The Freshfields Report,[5] published in 2005, stated that "integrating ESG [environmental, social and governance] considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions". This approach is supported by Regulation 28(2)(c)(ix) of the Pension Funds Act, which states that: "before making an investment in and while invested in an asset [the fund and its board must] consider any factor which may materially affect the sustainable long term performance of the asset including, but not limited to, those of an environmental, social and governance character".[6]

The Code for Responsible Investing in South Africa (CRISA)[7] puts forward a similar view. Its first principle states that an institutional investor "should incorporate sustainability considerations, including ESG issues, into its investment process as part of the delivery of superior risk-adjusted returns to the ultimate beneficiaries".

Principle 17 of King IV builds on these foundations by recommending that the governing body of an institutional investor organisation should ensure that it practices responsible investment in such a way as to promote the good governance within, and the creation of value by, the companies in which it invests. Responsible investing principles and practices are set out in the CRISA,[8] which accord with the Principles on Responsible Investing[9] and the International Corporate Governance Network Global Stewardship Code.[10]

7. EFFECTIVE DATE

Disclosure on the application of King IV is effective in respect of financial years starting on or after 1 April 2017, but immediate transition is encouraged. King IV replaces King III in its entirety.

ENDS

Acknowledgment: The IoDSA (Adapted

[7] Committee for Responsible Investment in South Africa, *Code for Responsible Investment in South Africa* (Institute of Directors in Southern Africa, 2011), available at: www.iodsa.co.za.

[8] Committee for Responsible Investment in South Africa, *Code for Responsible Investment in South Africa* (Institute of Directors in Southern Africa, 2011), available at: www.iodsa.co.za.

[9] Principles for Responsible Investing available at: https://www.unpri.org/about/the-six-principles.

[10] International Corporate Governance Network, *International Corporate Governance Network Global Stewardship Code*, (2016), available at: https://www.icgn.org/policy/stewardship-codes.