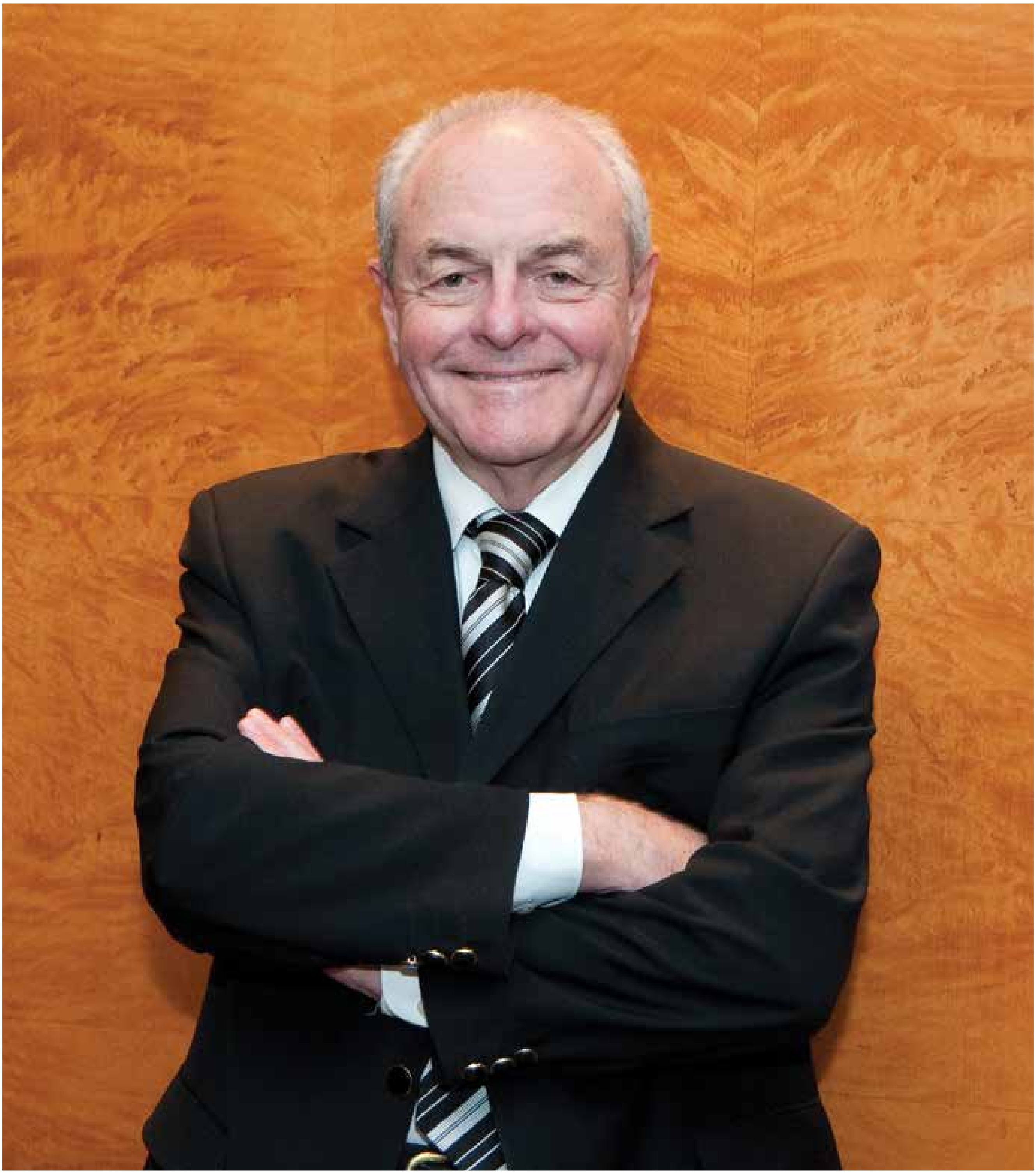

The future of governance

Since the 1990s, South Africa's King Reports on Corporate Governance have consistently been at the leading edge of governance best practice. Mervyn King, Chairman of both the King Committee on Corporate Governance in South Africa, and the International Integrated Reporting Council, tells *CSj* about the rationale behind the Report's latest update – King IV.

Many thanks for giving us this interview – could we start by discussing what is different about King IV?

'Certainly. As you may know, compliance with the King Report is a listing requirement of the Johannesburg Stock Exchange. Now what was happening was that listed companies wishing to do a rights issue, or companies applying for a listing, were being asked to complete an application register which listed the 75 principles of King III and required the company to disclose whether it was in compliance with each principle. If it was not in compliance, the company had to explain why. As you can imagine, these application registers were quickly becoming quite thick documents.

I came to the conclusion that this had become a mindless checklist approach to governance which is exactly what I didn't want. Being the chairman of the International Integrated Reporting Council (IIRC), I had very much uppermost in my mind the outcomes-based approach we took with the IIRC Framework. That document focuses on the process of moving from inputs to outputs. The question being asked was – how did the company make its money in the past and how will the company make its money in the future? Will it be a value-creation process in a sustainable manner?

So adopting that thinking, I turned my mind to the King III Report and asked, what is it we are trying to achieve? I and the other members of the committee concluded that we were to trying to achieve four outcomes, namely that the companies adopting these principles and practices would have:

1. an ethical culture with effective leadership
2. effective controls/oversight
3. a sustainable value-creation process, and
4. the trust and confidence of their stakeholders and legitimacy of operation.

So working from those outcomes we came up with 16 basic principles that, if adopted, would lead to the achievement of the desired outcomes. Then working with those principles we came up with practices which, if adopted, would lead to the achievement of the principles. Companies, whether they are SMEs, large listed companies or state-owned entities, should be adopting the 16 basic principles and therefore achieving good corporate governance, but the practices we left very flexible. These are international best practices in governance, for example requiring an audit committee, but we recognise that not all of these practices will be apposite for all businesses. So companies don't have to adopt the practices but they do have to explain how they intend to achieve the relevant principle. The reader of the explanations should be able to draw a reasonable conclusion as to whether or not the organisation is achieving those four outcomes.

So we turned the fourth iteration of the Report into a very mindful approach. There is a need for the board to apply its collective mind to these principles and to achieve the outcomes. That would be a huge added value for the company because anybody reading the report of a company that is achieving those outcomes would be able to see that it has the trust and confidence of the community in which it operates, that it has effective leadership and can therefore draw the inference that it is practising quality governance.'

Stakeholder inclusivity has been one of the defining characteristics of the King Reports ever since the publication of King I in 1994 – could we discuss your thinking on this issue?

'The primacy of the shareholder is a myth that has been debunked, but there is an interesting history to this. In the middle of the 19th century, wealthy families were contributing risk capital to ventures without any limits on their liabilities, and the governments of the day wanted them to contribute more money because they wanted to create more jobs as they promised their voters, as they still promise their voters today. The wealthy

Highlights

- King IV is outcomes based – its structure and principles are designed to evade the risk of tick-box compliance
- among the desired outcomes of King IV are the need for adopters to have an ethical culture with effective leadership, effective controls/oversight and a sustainable value-creation process
- the underpinning philosophies of King IV are integrated thinking, corporate citizenship, stakeholder inclusivity and the organisation as an integral part of society

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families were reluctant to do so because they were liable for the claims of creditors, employees and service providers, etc.

So that led to the creation by statute of an artificial person – the limited liability company. The suppliers of capital became shareholders and the capital they put in became equity capital. These companies started trading and built up their own working capital through borrowings, for which their shareholders were not be liable, and profits. If the liquidity of the company was adequate, shareholders could receive dividends, but their equity capital was the limit of their liability.

Moving from the 19th to the 20th century, the notion persisted that shareholders were the primary stakeholders and the owners of the company despite the fact that no one can own a company – it is a person in its own right. One can't say that directors must act in the best interests of the shareholders since that would be contrary to their duty of care, skill and diligence, clearly at common law all over the world, to act in the best interests of the company, of which they become the heart, mind and soul because the company has no heart, mind and soul of its own.'

The compliance mechanism adopted by King IV – the move from 'apply or explain' to 'apply and explain' – has gained a lot of attention around the world, including here in Hong Kong. What was the reasoning behind this?

'King IV is made up of 16 basic principles and they are very basic. As I mentioned, under those principles we added international best practices on how to achieve the principles. We accept that we can't create a one-size-fits-all expectation for every SME or large business in different jurisdictions around the world, so we came up with the 'apply and explain' model – companies have to apply the principles and explain their practices. They can choose not to adopt a particular practice, but they need to show how they are applying the relevant principle and therefore practising good governance.'

Would you like to see corporate governance codes globally adopt the 'apply and explain' model and an outcomes-based approach?

'Yes I would. The very reason I did this was that I had come to the conclusion that codes around the world had become a mindless tick-box exercise. The board needs to apply its mind to these basic corporate governance issues.'

Have you had any early indications of whether the outcomes-based approach of King IV is working?

'I have. The Report is being spoken about around the world but it has only been adopted so far in South Africa. Since it was implemented, you cannot believe the level of interest I have received from companies on the basic principles of King IV. I think there is a much wider recognition now that achieving the four outcomes we discussed earlier will be of huge value to companies. If you are involved in any kind of corporate transaction, you are going to want your share price to keep going up. Research has shown that 70% of the value of the company is made up of intangible assets which don't have to be added to the balance sheet according to international financial reporting standards. The 16 basic principles of King IV deal with tangible assets but they deal mainly with intangible assets, such as ethical culture and effective leadership. I think companies are recognising that if they achieve the outcomes of King IV, that is, if they create value in a sustainable manner and have a positive impact on society and the environment, they will gain more trust and confidence in the company which in turn will make the value of the company go up.'

King IV advocates integrated reporting (IR) – are you frustrated with the pace of the adoption of IR globally? Here in Hong Kong fewer than 10 companies are producing

integrated reports and I believe the latest figures suggest that around 1,500 companies have adopted IR globally.

'Let me say this, there are probably a million companies around the world thinking on an integrated basis. They have come to realise that operating in silos is what I call 'operating in silence' because HR doesn't talk to finance and finance doesn't talk to sustainability.

Integrated thinking is sweeping the world due to the realisation, and the empirical evidence to back it up, that integrated thinking reduces your costs and results in a better articulation of strategy. Integrated thinking means that everyone, from the chairman to the tea lady, understand where the company is going, what the company is trying to do and and they can all make a contribution. Once you've adopted that mindset you can move almost seamlessly to doing an integrated report, but integrated thinking is much more important to me than the number of companies doing integrated reports according to the IIRC Framework.

Having said that, in the last two months the Securities and Exchange Board of India has directed the top 500 companies on the Bombay Stock Exchange to do integrated reports. Two weeks ago Malaysia changed its corporate governance code to recommend integrated reporting and the Tokyo Stock Exchange is also now encouraging people to do integrated reporting.

If you look at the membership of the International Integrated Reporting Council, you can see that all the major world accounting and financial reporting bodies are represented, including the International Accounting Standards Board; the International Federation of Accountants; the Association of Chartered Certified Accountants; the Chartered Institute of Management Accountants (CIMA) and many more. They are now recommending integrated reporting because they recognise that most financial reports have become incomprehensible to the majority of people. Companies have a duty to be accountable to the providers of capital and should be talking in clear comprehensible language to them.'

What role can or should the corporate secretary play in implementing IR and raising corporate governance standards?

'The company secretary has a critical role to play to ensure that the board, on a collective basis, applies its mind to ensuring good corporate governance. This means more than just having the chairman check with the company secretary during a board meeting whether the company is in compliance with all the relevant laws and regulations. The company secretary needs to ensure that the company takes an outcomes-based approach to governance – then you are achieving something.

But I would go further. Companies have to understand the needs, interests and expectations of their stakeholders so that when management is developing strategy it does so on a more informed basis. Also at each board meeting there should be a report to the board and an agenda item on stakeholder relationships – the board needs to know the relationship between the company and its stakeholders. Now company secretaries can really drive this because they have a view right across all the departments in the company. So maybe its time

Career notes

In addition to chairing the committee that has taken his name – the King Committee on Corporate Governance in South Africa – Mervyn King plays a high-profile global role in governance, sustainability and corporate reporting. He is perhaps best known as the Chairman of the International Integrated Reporting Council, the Chairman Emeritus of the Global Reporting Initiative and as a member of the Private Sector Advisory Group to the World Bank on Corporate Governance.

He has been a chairman, director and chief executive of several companies listed on the London, Luxembourg and Johannesburg stock exchanges. In South Africa, he is the first Vice-President of the Institute of Directors; a Senior Counsel and former Judge of the Supreme Court of South Africa; Professor Extraordinaire at the University of South Africa on Corporate Citizenship; Honorary Professor at the University of Pretoria; and Visiting Professor at Rhodes University.

Professor King has consulted, advised and spoken on legal, business, advertising, sustainability and corporate governance issues in 53 countries and has received many awards. He is also the author of four books on governance and sustainability and sits as an arbitrator and mediator internationally.

The King reports: a brief tour

In 1993, the Institute of Directors in South Africa asked retired Supreme Court of South Africa Judge Mervyn King to chair its newly created committee on corporate governance. A year later that committee published the first 'King Report on Corporate Governance'. King I was not the first, nor even the best known of the codes of corporate governance that were starting to appear globally, but over the two and a half decades of its existence it has consistently been at the leading edge of governance best practice.

Back in the 1990s, the nascent governance codes tended to offer a fairly basic set of recommendations on the desired behaviour and structure of the board of directors, but the King Reports have taken a broader view – addressing the philosophies and core ethical issues underpinning the governance debate. King I, for example, stressed that boards of directors need to take account of the legitimate needs, interests and expectations of the stakeholders of the company. This was in contrast to the Cadbury Code in the UK, the best known governance code at that time, which still gave primacy to shareholders.

Subsequent King reports have pioneered many of the key concepts that make up 'best practice' in governance today.

> "the King reports have always been a reliable indication of where governance sensibilities are headed"

King II, for example, recommended sustainability reporting using the G2 Global Reporting Initiative guidelines when it came out in 2002. King III, published in 2009, pioneered integrated reporting. King IV, as described in this interview, puts its emphasis on an outcomes-based approach to governance and pioneers the 'apply and explain' compliance mechanism.

It is too early to say whether these innovations will be widely adopted by governance codes around the world, but certainly, based on their track record, the King reports have always been a reliable indication of where governance sensibilities are headed. As Sir Adrian Cadbury of the UK put it in his comments on King III: 'Governance yesterday focused on raising standards of board effectiveness; governance today on the role of business in society; and the course for governance tomorrow is set by King III'.

for the company secretaries to take on the role of the corporate stakeholder relationship officer.

Just to illustrate how the thinking about the company secretary role is changing, I've just returned from a visit to Australia where I spoke with Tim Sheehy, Director General of the Institute of Chartered Secretaries and Administrators (ICSA). He was the Chief Executive of the Australian division of ICSA which became the first ICSA division to adopt the term 'governance' as part of its name – it is now the Governance Institute of Australia. He is now on a mission to get better recognition globally for the governance role of the company secretary and I heartily support this because, as I have said, the role of the company secretary is critical.

King IV assumes that, if your organisation doesn't have a company secretary, in some juridictions company law doesn't require this officer, then you should appoint a governance officer to deal with these issues.'

In your article in the October 2010 edition of CSj, you warned: 'We have a window of approximately five to 10 years before the critical situation on planet earth becomes terminal.' Seven years on, how critical a position are we in today?

'We are in the fourth industrial revolution. We have nanotechnology, biotechnology, 3D-printing, many extraordinary things that we wouldn't have talked about seven years ago. I believe that IT is really going to help to make life on earth sustainable. It is quite clear that it is not an option to carry on business as usual because we have reached that ecological overshoot of using natural assets faster than nature is regenerating them, so we have to think differently. But if you look at great companies, they are thinking differently. They are aware that they cannot keep adding to the

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monetary bottom line at a cost to society and/or the environment. If they are, they are not adding value they are destroying value.

So I think IT will come to our rescue and I think that companies will need to pay a lot more attention to technological developments. In my foreword to King IV, I recommend three items that should always be on the agenda of the board:

1. stakeholder relationships
2. considering inputs to outcomes and thinking on an integrated basis, and
3. IT governance and security, because cybersecurity has become a critical issue.'

Are you optimistic about the future – particularly in the context of the current political climate with the rise of populist politicians advocating policies antagonistic to sustainability and governance reform?

'I'm quietly optimistic but it is a matter of shame that the private sector has moved ahead of political leaders. I believe our private sector leaders are thinking with greater clarity than our political leaders.'

Mervyn King was interviewed by Kieran Colvert, Editor, CSj.