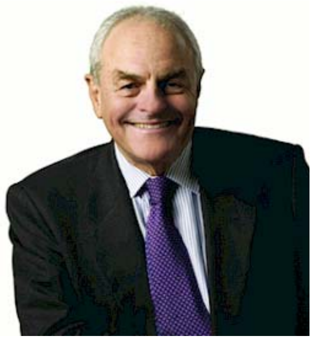

Profile: Mervyn King

Governance is King!

How the author of the new South African King III Code of Governance 2009 tries to change the tone at the top, the tune in the middle, and the beat of the feet at the bottom of an organization

Intro

In 1992, at a time when South Africans were adjusting to the fact that they would be moving towards a new democratic society, former South African Supreme Court Judge Mervyn King was asked to chair a private-sector body to draft corporate governance guidelines. The body became known as the King Committee, and its first report, issued in 1994, was regarded by many as ahead of its time in adopting an integrated and inclusive approach to the business life of companies, embracing stakeholders other than shareholders. The Committee subsequently revised its report in 2002, and more recently in 2009. The current *King Code on Corporate Governance for South Africa* (also called "King III"; see also "Highlights of King III") is again pointing to the next level in governance by encouraging the integration of governance and sustainability into the strategy, operations, and reporting of an organization. In this interview, Prof. King walks us a couple of steps up the stairs.

Brief Mervyn King bio

South African Mervyn King has chaired and been a director of several companies listed on the Johannesburg Stock Exchange, and is probably best known as the chairman of the King Committee on Corporate Governance in South Africa. Prof. King was the South African representative at the ICC International Court of Arbitration in Paris for nine years, and still acts as an arbitrator and mediator in commercial disputes. He is associated in numerous ways with several other organizations, including the Commonwealth Association of Corporate Governance, the World Bank, and the United Nations.

See also Hwww.mervynking.co.zaH.

Highlights of King III

When King III was launched in September 2009, the "father" of corporate governance, Sir Adrian Cadbury of the UK, said about the code, "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." Here are some of the King code's landmark elements:

- The philosophy of the King III code revolves around leadership, sustainability, and corporate citizenship. Responsible leaders direct company strategies and operations with a view to achieving sustainable economic, social, and environmental performance.
- The code is not designed on a "comply or else" basis, nor on a "comply or explain" basis, but on an "apply or explain" basis. This provides boards with the freedom to apply the recommendation differently, or apply another practice, if they consider that to be in the best interest of the organization, but then they must explain the departure from the recommendation.
- The principles in the code are drafted so that every entity—public, private, or non-profit—can apply them and, in doing so, achieve good governance.

- It follows the "stakeholder inclusive" model, in which the board of directors should consider the legitimate interests and expectations of stakeholders, on the basis that this is in the best interests of the company.
- Alternative dispute resolution (negotiation, mediation, and expedited arbitration) as a management tool and a dispute-resolution mechanism.
- The code adopts a risk-based internal audit approach to determine whether controls are effective in managing the risks which arise from the strategic direction.
- Introduction of information technology (IT) governance in King III, provides the most salient aspects of IT governance for directors.
- The code recommends integration of economic, social, and environmental reporting, recording how the company's business has impacted positively and negatively on the community, and how it intends to enhance those positive aspects and eradicate or ameliorate the negative aspects in the year ahead.

The revised *King Code of Governance for South Africa* (King III) has come into effect on March 1, 2010.

Extraordinary socio-economic development

"Who could ever have dreamt 150 years ago that some of the then-start-up companies would accumulate such huge pools of human and monetary capital, and influence the lives of millions of people as the multinationals of today are doing? Together with this transformation, an extraordinary socio-economic development has occurred. The greatest shareholder today is no longer the wealthy family, but it is the individual via his or her financial institution and pension fund. The same individual is also the employee of the company; the customer who chooses between the products of company A or company B; the voter for the government of the day and for the trustee of the pension fund. In addition, the individual is also a citizen of a country who expects his or her neighbor to act as a decent citizen, and as a consequence today, the individual citizen expects the corporate citizen to act as a decent citizen.

"One of the things that terrifies me about the recent financial meltdown is that governments will overregulate from a financial point of view and forget about the sustainability crisis, which will be ongoing long after the financial crisis comes to an end."

"I really believe that the customer of tomorrow is becoming very alive to these things (see also 'Terminator for President'). And companies are becoming more and more alive because they realize how it is going to impact their business in the years to come."

Terminator for President

"I really enjoyed the *Wall Street Journal* story of the 12-year-old boy in Los Angeles, California, reported during the McCain and Obama presidential election. To his father's question, 'If you could vote, would you vote for McCain or Obama as your new president?' the boy responds, 'Neither. I want the Terminator, Mr. Schwarzenegger.'[1] And his father says to him, 'What does he know about the financial meltdown, about Iran and Iraq, and about all the other problems we have today?' The boy responds, 'Probably not much, but I do know that he has done more to improve the quality of the air, the soil, and the water in the state of California than any other governor in any other state in America. And if he became the president of the US, he would do that for the whole of America. And when I am your age, these are going to be my problems.' And the *Wall Street Journal* ended the article by saying, 'Leaders of the corporate world: know that this is your customer of tomorrow.' And that is the reality."

Come out of the silo

"One of the things that terrifies me about the recent financial meltdown is that governments will overregulate from a financial point of view and forget about the sustainability crisis, which will be ongoing long after the financial crisis comes to an end.

"We have to stop destroying the quality of life on Earth, and companies are making the hugest impact on planet Earth. Therefore, corporate governance can no longer be looked at as 'in a silo' how companies are steered and directed by boards, how they are managed by management, or controlled by shareholders. It's got to be integrated!

"Governance, strategy, and sustainability are becoming more and more inseparable because the long-term survival of organizations is no longer only affected by economic factors, but also by social and environmental ones (see also 'The Coca-Cola Case'). If you are practicing good governance in working out the long-term strategic direction of a company, you also need to assess the social and sustainability issues pertinent to the business of that company."

The Coca-Cola Case

"When you look at large companies like the Coca-Cola Company, they can no longer afford to separate their governance, strategy, and sustainability. Take water, for example, which is an increasingly scarce commodity on planet Earth, and Coca-Cola is using a lot of it in the production of their beverages.

Some ten years ago, Coca-Cola developed its [3-R water strategy] focused on reducing, recycling, and replenishing. The reason for that is twofold:

1. In its strategic thinking, the board realized that their greatest asset is reputation, their Coca-Cola brand, which makes up some 70% of their market capitalization. In order to be seen as a good corporate citizen, they had to do that.

[1] Arnold Schwarzenegger is an Austrian-American actor—famous for his role as the Terminator—and politician, currently serving as governor of California.

2. Secondly, from an investor's point of view, I think Mr. Warren Buffett[2] would be very unhappy as a shareholder if he thought the board hadn't paid attention to having access to drinkable water in order to continue making Coca-Cola around the world.

Now they recycle millions of liters of water every day. The essence is that organizations need to look and understand what their sustainability issues are, similar to what water is for Coca-Cola."

Simplify business reporting

According to our previous studies, business reports have become too complex for the average reader to understand. What should be done?

"I am hoping that, one day, the whole world will be on one financial reporting standard, and I think IFRS should be the standard. However, if you just look at the financial reports of today, then you immediately understand that the average person can no longer understand them. Even some chartered accountants no longer fully do.

"We are all guilty of making financial reports complicated. As a corporate lawyer with 40 years of experience, I tend to write in this corporate legal and accounting jargon. We all do. We, the preparers of such reports, have got to change for the benefit of the users. We need to develop an easier form of reporting written in more understandable language, especially for small- and medium-sized entities (SMEs). We need to develop a simplified balance sheet, a simplified profit-and-loss statement, and simplified related notes in understandable language, so that the average person can read it and understand it. In most jurisdictions today, companies are entitled to issue a shortened report which can be given out online—so you even save some trees—and if the stakeholder wants additional information he or she can apply for the full report, or drill further down on the website. That way we create more usefulness of financial reporting and a better understanding of the business of a company."

Also for investors

"When pension funds, for example, have to make investment decisions on behalf of the ultimate beneficiaries—the individuals contributing to their pension fund—they need to make an informed assessment of the sustainability and the long-term success of that company. They need more information than simply the balance sheet, the profit-and-loss statement, and the related notes. Therefore, companies need to report on how the business of the company impacts, both positively and negatively, on the community in which it operates. As soon as you get all the social, environmental, and economic results of an organization in one integrated report, it starts showing the true performance of that organization (see also 'A More Positive Opinion Through More Disclosure')."

[2] CEO of Berkshire Hathaway, and a large investor in the Coca-Cola Company.

A More Positive Opinion Through More Disclosure

"The Global Reporting Initiative (GRI) recently published a survey[3] among readers of financial reports. It found that readers of a report which disclosed how a company's business had impacted the community and the environment in which it operated, including the financial aspects, had formed a more positive opinion about that company—and had more trust and confidence in the products and services of that company—than about a competitor that did not report on an integrated basis. So reporting on the essence of the business, the business itself, and its impact on society and the environment, has become absolutely critical and is good business."

"We have to accept that the world has moved on. And we have got to prepare business reports in the way readers have changed. Denmark recently changed its Financial Statements Act, so now they made it a law that their top companies also have to report on how their businesses have impacted society and the environment. Also the UK Companies Act effectively says the same already. If you look at the recent amendment, it talks about companies having to disclose their impact on society, and other countries are following suit."

Adopt integrated reporting

How should boards adopt this new approach of integrated reporting?

"Look at most social and environmental reports and you will see that they are written completely separately from the financial reports about the business. Companies have to realize that their social and environmental performance is absolutely integral to their whole business and the sustainability of their company. That requires a mindset change at the top, and then the top has to make sure that the message is carried further down the organization.

"You all have heard of 'the tone at the top.' I talk about 'the tone at the top, the tune in the middle, and the beat of the feet at the bottom.' The board and top management have to make sure that the whole company has bought into the new strategy and is facing in the same direction. I know from my executive days that if you get your strategy right and you get buy-in, you get ordinary people to achieve the most extraordinary things! But if you don't get it right and it doesn't fit in with the milieu of the day, you can have the most extraordinary people, but you won't even achieve ordinary things."

Stop mindless compliance

Can regulation steer desired behavior?

"I believe more in principles rather than in rules, and I don't believe in the use of criminal sanctions to steer desired behavior. I think the 'comply or else' regime of, for example, the US Sarbanes-Oxley (SOX) Act does not work, because then you get mindless compliance. What people with statutory compliance do is develop manuals to tick off compliance. Engineering firms that had to comply with SOX had to hire accountants and lawyers rather than engineers, simply because of the fear of criminal prosecution!

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[3] *Count me in -The readers' take on sustainability reporting* (2008)

"There should be civil remedies instead. Maybe there could be an integrated reporting oversight body to say, 'We do not accept your explanation as to why you have not reported on the impact of your business on society and the environment.' And there could be a name-and-shame game, but the ultimate sanction is the marketplace and the ultimate compliance officers are a company's stakeholders.

"One does not need to go into great detail, either, such as SOX did, which results in rigidity in process. We need flexibility in practice. Also, to have 'one size fits all' is not possible, and legislation on governance takes the focus off enterprise. This in turn impacts the ultimate social and economic responsibility of a company, which is performance, not conformance."

Develop investor codes

How is it that, even after this past financial crisis, directors with a tarnished reputation can continue as directors?

"I always say that shareholders deserve the directors that they appoint, similar to the governments they vote into power. Shareholders who maintain a director who:

- Has not proven to be a good non-executive director;
- Has not properly applied his mind and good governance principles;
- Has not asked those questions that make management really think; and
- Mindlessly agrees with a credit committee that makes a recommendation because a rating agency has approved something

should not complain because it is their fault.

"Certainly, if I were a shareholder I would not vote for such a person. So there it is: if shareholders have the ultimate say, they should use their powers well, and this is where the investor code becomes so important. We are developing a responsible investor code in South Africa for our financial institutions to actually carry out their responsibilities, to ensure that the directors they vote for are directors with the ability and capacity to carry out their duties.

"There is absolutely no doubt that institutional investors, such as the trustees of pension funds, have an onerous duty, I believe even more onerous than a director. They are making decisions which will impact people's lives 30 to 40 years hence, and they must assess the quality of governance, of management, and all these so-called non-financial aspects which make up the economic value of a company, before investing your and my money in a company. That is their duty, and I think a responsible investor code is one way of ensuring and monitoring good governance, because those are the major investors in equities."

Balance risk and reward

Before the crisis, companies that were taking huge risks seemed to take in huge profits as well. Those that took a more conservative course were under severe pressure from their investors to also engage in these risky ventures. How should companies reconcile good governance with investor demand for profit?

"The answer is that the ultimate duty of the director is sustainable performance (see also 'The curator'). Your duty as a director is, *inter alia*, to balance risk and reward. Why is it that your pension fund buys equities in a company, takes positions in the money market, and has money in the bank? It invests and takes positions because it expects a better return than on money in the bank and it does not put all its eggs in one basket.

The Curator

"I always draw the analogy between a director and a curator. Imagine a young person who has been injured in a car accident and becomes incapacitated, and that you are asked to care for that person for the rest of his or her life. Medically, that person could live to 90 today. Well, as the curator, you would plan for both the short term and the long term, you would apply your mind honestly, and you would take great care to act in the best interest of that person. Those duties are exactly the same for taking care of a company in the role of a director."

"The director has to make sure that he or she gets the balance right between performance and conformance. If you focus too much on conformance, you become too administrative and you forget about enterprise. You cannot do that. So, whatever happens in the world, a director must be aware that he or she has to take risk for reward.

"That is why the business judgment rule was developed in the US and in several other countries. To support directors where they have the greatest exposure, which is their duty of care. None of us gets those business calls right all the time because we are dealing with the uncertainty of the future. We are dealing with the foresight in the heat of the boardroom. Three or four years later, when a company or some stakeholders say that you have acted negligently, they have got the comfort of sitting in the chair of hindsight. But you cannot equate hindsight to foresight! And we have to take risk for reward. That is part of our duty and that is why the business judgment rule ameliorates that. Performance is the ultimate responsibility of a director, and again, that is why I am opposed to something like SOX, which focuses on conformance and dilutes the necessary drive for enterprise."

How do we enable defensive directors to get the balance right between conformance and performance?

"A director has to apply his or her mind to all these things. That is why being a director is a continual learning process. Directors have to realize that their ultimate responsibility is social, environmental, and economic performance. It is the moral and economic imperative of the 21st century that we perform economically, but at the same time are concerned with social and environmental objectives. You can't escape it, that we have to perform on all these aspects, otherwise the pension funds, society, and stakeholders will not benefit. And directors appreciate that they have to apply their minds intellectually and honestly. It is not easy, but we have to do it. It is our job!"

Develop a remuneration framework

Executive remuneration is often seen as an issue. What should be done to get it right?

"What we have recommended in the King III report is that boards should adopt a policy or a framework for the remuneration of their senior executives. As an expert advisory to the board, the remuneration committee should develop the whole framework via benchmarking with other organizations and getting input from experts. That makes a framework more informed than any shareholder could be, and hopefully shareholders will accept the framework recommended by the board in a non-binding vote when the framework is put to them.

"We also think, if you look at King III, that if an executive gets an additional bonus, it must be related to something that he or she has personally contributed. For example, if there is a currency change and the company has a windfall profit of 50 million dollars, none of that should be taken into account in assessing the performance bonus, because he or she has not contributed to that. So it has to be something he or she has done in management to improve performance in order to get that bonus.

"And for non-executive directors you say upfront, 'This is the fixed fee for the year,' and let the shareholders approve that in the general meeting. And the next year you do the same.

"Put the remuneration framework to a non-binding vote to shareholders, so you get an indication from your shareholders as to whether you are in the right ballpark in regard to remuneration. And then you fix that remuneration. So, we think that is the answer!"

Provide assurance on integrated reports

How could we ensure that this more holistic approach of integrated reporting will be balanced with respect to the positives and negatives?

"If you look at King III, it says it must be both positively and negatively reporting. Now, what good is that if there is no assurance? I think it is valueless. That's why we recommend an external opinion that this integrated report is a candid, open, and transparent disclosure of what has happened in the company. And the only profession that can give this assurance is the accountancy profession. It is an extremely exciting opportunity for the auditor and it is the future of the profession!

"Unfortunately, this is also where the risk of litigation arises for the external auditors. If you look at the accountancy firms, more and more they have been called upon to provide assurance on integrated reports."

Mitigate litigation

Litigation is another issue that is seen to hinder improvement. How can we solve this?

"My answer to litigation has always been that I believe governments need to legislate the reasonable apportionment of blame and damages, because after a business failure people are inclined to sue the auditor first, because they believe auditors have the deepest pockets and the best insurance cover. To me this is inequitable because we know that when there is a corporate failure, it is not the external auditor that is solely to blame, if at all. Management, directors, and other stakeholders sometimes all contribute to the failure. So there should be an apportionment of blame. Courts in several jurisdictions around the world now have the power to apportion loss when, for example, in a two-car traffic accident, both drivers are each 50% to blame. But courts in most jurisdictions around the world are unable to say, in the case of a corporate failure, that the board was 10% to blame, management 30%, external auditors 15%, and so on."

How do we get governments to take this issue on board?

“If you say to governments, ‘Let external auditors provide the assurance, but exonerate them completely,’ that won’t wash. But if you say that damage must be apportioned according to the contribution to the failure, then the government makes clear that everybody has to put their shoulder to the wheel.”

Let’s start now

Is there anything that is not said that should have been said?

“Many things! We are informed people and we know that there are many loose ends. We’ve got to start, however, and I think the accountancy profession is very important in making these changes happen. If we start now, at least we have a chance of having a sustainable future. Otherwise it will be too late for mankind on planet Earth.

“In my book, *Transient Caretakers*, I quote Catherine Sullivan, who was the first American woman to walk in space. In 1984 she was up in space and saw that beautiful blue planet below. And she thought, ‘I have to return to Earth, to this degraded Earth, and I know that every household is still contributing to the degradation of the Earth.’ That was 25 years ago. And since then, how far have we progressed? We don’t learn very quickly.”

Key recommendations of Mervyn King

1. If you are practicing good governance in working out the long-term strategic direction of a company, you also need to integrate the sustainability issues pertinent to the business of that company.
2. We need to develop a simplified balance sheet, a simplified profit-and-loss statement, and simplified related notes in understandable language, so that the average person can understand it.
3. Companies need to report on how the business of the company impacts, both positively and negatively, on the community and the environment in which it operates.
4. If you get your strategy right and you get buy-in, you get ordinary people to achieve the most extraordinary things! But if you don't get it right and it doesn't fit in with the milieu of the day, you can have the most extraordinary people, but you won't achieve even ordinary things.
5. Develop a responsible investor code for financial institutions to actually carry out their duties, to ensure that they vote for directors with the ability and capacity to in turn carry out their duties.
6. Directors have to realize that their ultimate responsibility is social, environmental, and economic performance.
7. Boards should adopt a policy or a framework for the remuneration of their senior executives and put it to a non-binding vote to shareholders, so they get an indication from their shareholders as to whether they are in the right ballpark.
8. If an executive gets an additional bonus, it must be related to something that he or she has personally contributed.
9. An external opinion on integrated reports is essential to ensure that they are a candid, open, and transparent disclosure of what has happened in an organization.
10. Governments need to legislate the apportionment of blame and damages for a corporate failure (to make clear that everybody has to put their shoulder to the wheel).
11. If we start now, at least we have a chance of a sustainable future on our planet. Otherwise, it will be too late.

We welcome your feedback on these recommendations. To provide us with your feedback, please complete this brief survey.