The King Committee published the Draft Consultation of the King IV Report on Corporate Governance for South Africa 2016 (King IV) on 15 March 2016. Comments are due by 15 May 2016.

While we acknowledge that most companies 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-based 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 company. In this regard it is clear that King IV aims to establish a balance between conformance and performance. The Code is bolder 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. While we believe that this matter still warrants debate in the South African context, we acknowledge that the suggestions 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 take a closer look at recommendations regarding the remuneration policy, approval and disclosures in terms of King IV and practices from an international perspective. We also consider the prevalence of stakeholder activism in the context of the remuneration debate.

From an application point of view, the King IV Report has been structured as a framework that can be applied more easily across listed and unlisted companies, profit and non-profits as well as private and public entities. As such the Code refers to "organisations" and "governing bodies". For purposes of this publication we refer to "companies" and "Board".

Remuneration of directors is one of the most debated topics in the corporate governance arena, due to the tension between stakeholders demanding to understand directors' remuneration and the directors' desire for the privacy of their financial affairs. The tension is exacerbated by the high levels of inequality between employee and executive remuneration levels. In line with international developments, remuneration is receiving far greater prominence in King IV. The Code reiterates the fundamental ethical leadership characteristics of accountability and transparency with renewed vigour by requiring a three part disclosure of remuneration:

- a background statement that provides the context for the remuneration policy and decisions
- an overview of the remuneration policy and
- the remuneration awarded, accrued and paid to each director and prescribed officer as a result of the implementation of the policy.

In addition to the above, the Code recommends that shareholders be provided with the opportunity to pass separate non-binding advisory votes on the policy and its implementation. Where either the policy or its implementation report is not adopted by a vote of at least 75%, compulsory shareholder engagement is required and disclosure of the steps taken to engage shareholders in this regard must be made.
Further to the shift in thinking from short-termism to long-term sustainability based on ethical principles, King IV recommends that the Board should ensure that remuneration is used as a tool to ensure that the business creates value in a sustainable manner within the economic, social and environmental context in which the company operates. To this end, the Board should establish a remuneration committee, the role of which is to recommend to the Board a fair and responsible company-wide remuneration policy that promotes the creation of value in a sustainable manner. Pursuant to its outcomes-focused approach, King IV does not go into great detail on the recommended practices for the remuneration committee as was done in King III.

While King III required organisations to have an approved remuneration policy that is voted on by shareholders in the form of a non-binding advisory vote, King IV takes this further by stipulating the minimum requirements of the remuneration policy to be voted on. According to King IV, the remuneration policy should address all of the following:

a. base salary and financial and non-financial benefits
b. variable remuneration, including:
   i. short- and long-term incentives (including deferrals)
   ii. loss of office payments
   iii. recruitment and retention payments
   iv. any other commissions and allowances, and
c. the structuring of non-executive directors’ fees

Many of the above recommended components of the remuneration policy align with the directors’ remuneration disclosure required in terms of the Companies Act.¹

¹For further information on the Companies Act requirements, refer to our FAQ guide on the disclosure of directors’ remuneration. http://www2.deloitte.com/za/en/pages/audit/articles/directors-remuneration-guide.html

“Executive directors’ remuneration should be designed to promote the long-term success of the company. Performance-related elements should be transparent, stretching and rigorously applied.”

The UK Corporate Governance Code, September 2014
In the true spirit of integrated thinking, King IV acknowledges that fair and responsible remuneration is a consideration of a company’s corporate citizenship. In line with this integrated approach, King IV suggests that the social and ethics committee, in conjunction with the Board and remuneration committee, reviews fair and responsible executive remuneration practices in the context of overall employee remuneration. This recommendation aligns with the principle of ethical leadership and is designed to ensure that executive remuneration is determined within the context of overall employee remuneration. It is interesting that King IV assigns this function to the social and ethics committee, and not simply to the remuneration committee.

King IV recommends that the Board oversees that the implementation of the remuneration policy results in all of the following:

- Attracting, motivating, rewarding and retaining talent
- Linking variable remuneration with both organisational and individual employee performance
- Measuring variable remuneration in relation to sustainable value created across the whole of the economic, social and environmental context and in accordance with enhancement or diminishment across the capitals that the organisation uses or affects.

These intended results are in accordance with recommendations of King III, however King IV now recommends detailed and specific disclosure on the policy and its implementation (discussed below). In light of the above, in order to properly draft the remuneration policy, the Board, in conjunction with the remuneration committee (and to some extent the social and ethics committee), will need to clearly articulate and disclose the link between strategy, sustainable value creation, performance and remuneration.

Compensation Clawbacks

The Securities and Exchange Commission (SEC) in the USA recently issued a proposed rule aimed at ensuring that executives do not receive “excess compensation” if the financial results on which previous awards of compensation were based are subsequently restated because of material noncompliance with financial reporting requirements.

Under the proposed rule, issuers would be required to adopt a written policy requiring them to recover “excess” incentive-based compensation awarded to any individuals (including former employees) that served as an executive officer during the three most recently completed fiscal years preceding the date on which it is determined that a qualifying financial restatement is required, provided that the executive officers were awarded more incentive-based compensation than they would have received if the financial statements had been prepared correctly. The ICGN Guidance on Executive Remuneration also recommends adopting a remuneration “claw back” policy.
King IV recommends that shareholder approval in respect of remuneration is sought as follows:

- The remuneration policy should be tabled for a non-binding advisory vote by shareholders every two years, each time that a material change to the policy is approved by the Board, or whenever the policy was not adopted by at least a 75% vote the year before. The non-binding advisory shareholder vote appeared in King III as well, however, King III did not foresee any consequence where the shareholders do not support the policy. It is interesting to note that King still recommends a non-binding advisory vote by shareholders, whereas a number of other jurisdictions (including the UK, Norway and Australia) now afford shareholders a deciding vote on executive remuneration.

- The implementation report should be put to a non-binding advisory vote by shareholders every year. This is a new recommendation introduced by King IV and is more closely aligned to international trends where shareholders are increasingly having a ‘say on pay’.

- The fees of non-executive directors of companies must be approved by a special resolution of the shareholders within the previous two years. This recommendation is echoed in King III as well as in the Companies Act.

In addition to the afore-mentioned, King IV proposes that should there be a 25% or higher advisory vote against the adoption of the policy or implementation report, the remuneration committee should be proactive in taking steps to address shareholders’ concerns. The remuneration committee should ensure that there is disclosure in the following year of the steps taken, the nature of the engagement with shareholders and the outcomes. It is interesting to note that King IV mentions shareholder engagement rather than stakeholder engagement. It would however be advisable, in the spirit of the stakeholder inclusive model, for the Board and remuneration committee to assess whether it is necessary to engage with other key stakeholders in such a situation. It is foreseen that the social and ethics committee will play an important role in this regard.

In terms of the European Union Shareholder Rights Directive Proposal, shareholders are given the right to approve the remuneration policy and to vote on the remuneration report, which describes how the remuneration policy has been applied in the last year. All benefits of directors in whatever form will be included in the remuneration policy and report. Such report facilitates the exercise of shareholder rights and ensures accountability of directors.
As part of its mandate, the social and ethics committee must ensure fair and reasonable executive remuneration in view of overall employee remuneration, and as such the committee will have to work closely with the remuneration committee in its efforts to achieve these policy objectives.

Pursuant to the ethical leadership characteristics of accountability and responsibility, King IV suggests that an advisory vote against the remuneration policy or implementation report be taken into account in the performance evaluation of the remuneration committee. Accordingly, the remuneration committee will have to take cognisance of the above as this will inform the effectiveness of the committee as a whole. It is clear that King IV pushes the mandate of the remuneration committee beyond the design of executive remuneration packages to include the justification of the link between remuneration, value creation and key performance indicators within the social, economic and environmental context.
King IV is premised on the stakeholder inclusive model whereby directors should consider and balance the legitimate and reasonable needs, interests and expectations of all stakeholders in the best interests of the company.

It welcomes productive stakeholder engagement by encouraging stakeholders to engage with the companies that they have a stake in to promote the principles and outcomes contained in the Code. Stakeholders have an obligation to ensure that the company acts as a responsible corporate citizen and as such they should exercise their rights as well as their legitimate and reasonable needs, interests and expectations in a responsible manner towards the creation of value within the context that the company operates.

Stakeholder activism is an important consideration for the Board particularly in light of the often contentious remuneration discussion. In an effort to promote transparency, King IV recommends that the Board ensures and oversees regular dialogue with shareholders, to create and maintain a mutual understanding of what performance and value creation constitutes for the purpose of evaluating the remuneration policy. Again, it is advisable for Boards to consider extending this dialogue to other key stakeholders of the company. Furthermore, it is advisable for the remuneration committee to assist the Board with the dialogue with shareholders to ensure that they are comfortable with the correlation between directors’ performance, their individual and collective contribution to value creation and associated remuneration. This links to the King IV recommendation for shareholder engagement where there is a 25% or higher advisory vote against the adoption of either the remuneration policy or the implementation report, as described above.

The notion of constructive stakeholder engagement is echoed in King III and should be aimed at ultimately promoting enhanced levels of corporate governance in a company.

"Investors have a distinct role in relation to executive remuneration. Investors have a fiduciary responsibility as well as a strong economic interest in remuneration. No aspect of corporate governance touches as many drivers in terms of performance, risk and incentive, or is ultimately more critical to long-term alignment of interests. However, investors are not, typically, insiders and in almost all cases are not in a position to dictate executive remuneration practices."

ICGN Guidance on Executive Remuneration, 2012
A recent study\(^2\) investigated the “executive pay gap” perception among people from different countries and backgrounds. The study explored how much people think CEOs should ideally be paid relative to unskilled workers in an organisation and what they estimated CEOs are actually taking home. In South Africa, respondents felt that the ideal ratio should be approximately 9:1 (global ideal 4.6:1), however, these respondents estimated that the ratio was nearly 17:1 (global estimate 10:1).

The actual CEO to unskilled worker ratios were only available for 16 countries in the study (which did not include South Africa). A consistent finding across all countries analysed was that the respondents’ estimates were staggeringly lower than the actual amounts CEOs earned. Alongside are results of a few countries:

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One of the boldest changes in King IV is renewed focus on transparency and accountability regarding the disclosure of directors’ and prescribed officers’ remuneration. King IV requires a three part disclosure relating to remuneration including the remuneration background statement, policy and implementation as follows:

- Remuneration background statement disclosure provides the context for remuneration considerations and decisions. Specific reference should be made to the following considerations:
  a. internal and external factors that had an influence on remuneration
  b. the focus areas of the remuneration committee and any substantial changes to the remuneration policy
  c. the opinion of the remuneration committee on whether the implementation of the policy achieved its stated objectives, and
  d. future considerations

“Remuneration levels may take into account relevant benchmarks and market conditions but these criteria should not be used exclusively to justify levels of remuneration or plan design. Too much reliance on relative peer analysis leads to unjustified escalation in executive pay. Each plan should be tailored to the unique circumstances of the company as well as the responsibilities of the position(s) in question and the experience and expertise of the individual.”

ICGN Guidance on Executive Remuneration, 2012
• The brief overview of the remuneration policy should include:
  a. the high-level principles in accordance with which remuneration is determined
  b. for executive directors and prescribed officers:
    - the elements and design principles informing the remuneration system
    - details of obligations in employment contracts which could give rise to remuneration payments or payments for loss of office
    - illustration of the application of remuneration policy under different performance scenarios
  c. in respect of employees other than executive directors and prescribed officers, a high-level overview of the elements and design principles informing the remuneration
  d. a statement of how fairness and responsibility in the context of overall employee remuneration was taken into account when determining remuneration of executive directors and prescribed officers
  e. in respect of non-executive directors, the basis of computation of fees
  f. justification of benchmarks
  g. reference to an electronic link to the full policy for public access

• Remuneration implementation disclosure should include all of the following:
  a. the total remuneration paid and accrued to each executive director and prescribed officer, including basic salary, benefits, short-term incentives (including those deferred), loss of office payments, other allowances and long-term incentives, all reflected at fair value
  b. details of deferred short-term and long-term incentives awarded but not yet paid or vested at the end of the financial year in respect of each executive director and prescribed officer
  c. awards realised and paid to each executive director and prescribed officer from deferred short-term and long-term incentives
  d. the links between variable remuneration awarded and performance, in terms of sustainable value created across the economic, social and environmental context; or in terms of the enhancement or diminution across all capitals that the organisation uses or affects
  e. whether remuneration consultants have been used and their relationship to the company and directors or prescribed officers
In order to meet the above disclosure requirements, it is crucial that the Board has an intimate understanding of how value creation, performance and reward are linked in the business. It is evident that whereas King III and the Companies Act\(^3\) ask the “what” in respect of remuneration disclosure, King IV goes beyond the numbers and also examines the “why”. This substantial enhancement in disclosure closely aligns to international trends where transparency is at the forefront of the governance agenda. Indeed, such disclosures strengthen the disclosure principle in King IV of enabling stakeholders to make an informed assessment of the performance of the company and its ability to create value in a sustainable manner. Furthermore, the remuneration disclosure requirements are intended to achieve a disclosure benchmark to facilitate the performance of a comparative analysis of remuneration by companies.

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**Employee to CEO Pay ratio**

The Securities and Exchange Commission (SEC) in the USA recently issued a final rule on pay ratio disclosure*.

In terms of the rule the annual disclosure must include the ratio of:
- the median of the annual total compensation of all its employees (excluding the CEO) and
- the annual total compensation of its CEO

* Registrants must adopt the final rule for their first fiscal year beginning on or after January 1, 2017.

For further information on the Companies Act requirements, refer to our FAQ guide on the disclosure of directors’ remuneration.

• Does the strategy of the company identify the core purpose of the company and set its longer-term direction?

• Is the strategy expressed in terms of performance that creates value in a sustainable manner within the economic, social and environmental contexts in which the company operates?

• Do the key performance indicators against which the performance of directors and prescribed officers is measured take into account the contribution by the respective individual to value created across the economic, social and environmental contexts in which the company operates?

• Is the remuneration payable to directors and prescribed officers linked to the aforementioned key performance indicators, and can the Board illustrate and explain the link?

• Has the Board overseen that the social and ethics committee has considered the socially responsible component of the remuneration policy?

• Does the Board engage with shareholders regarding the remuneration policy and implementation prior to the non-binding advisory vote?

4 The Guardian, Credit Suisse chief asks for ‘significant reduction’ to annual bonus, Jill Treanor, 8 February 2016 http://www.theguardian.com/business/2016/feb/08/credit-suisse-chief-asks-for-significant-reduction-to-annual-bonus

Good Governance in Action

“I have asked the board of directors for a significant reduction in my bonus. Within the management team, the cut is greatest in my case. I cannot demand sacrifices from others and not make any myself. It has been substantially reduced.”

Tidjane Thiam, CEO of Credit Suisse who asked the board of the Swiss bank to cut his pay after a year in which the bank posted its first loss since 2008.
King IV's bold move to go beyond the numbers and interrogate the underlying basis for remuneration aligns South Africa with international trends where accountability and transparency are at the forefront of the corporate governance agenda. King IV successfully links the principles of responsible and ethical leadership with greater accountability and transparency with respect to executive remuneration. These recommendations build on the disclosure requirements implemented through the Companies Act, but takes it a step further in that it proposes that Boards identify and illustrate a clear link between the performance of the company and each executive and the remuneration received by each director.

In light of the varying socio-economic landscape and high levels of income inequality in the country, executive remuneration remains under scrutiny. As such, boards should strive for greater accountability and transparency in order to explain executive remuneration, not only in light of the performance of the company and its directors, but also in light of over-all employee remuneration. Stakeholder engagement in the corporate arena remains critical for the harmonious and productive functioning of business and society.