PRACTICENOTES

King III Chapter 1
Ethics Management

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Ethics management for a culture of organisational integrity

Corporate ethical culture

The ultimate objective of managing organisational integrity is to build an ethical corporate culture. Apart from informal aspects of culture-building — such as informal norms, role modelling and mentoring, rituals, myths and stories, and language use — a company builds an ethical culture in a formal way by compiling an ethics risk and opportunity profile; developing a code of ethics; integrating ethical standards; and reporting on and disclosing the company’s ethics performance.

Ethics risk and opportunity profile

Compiling an ethics risk and opportunity profile (hereafter “ethics risk profile”) requires a number of key decisions:

Responsibility for ethics risk profile

Although responsibility for compiling the company’s ethics risk profile lies with the board, it may not be in a position to do so. Consequently, it is likely to be delegated to an appropriate board committee, for example, the internal audit committee or risk committee, or to a specific operational area in the company, for example, risk management or human resource management.

Identifying stakeholders

A company identifies its ethics risks through a process of engagement with its stakeholders. Both internal stakeholders (managers and employees on all levels) and external stakeholders (shareholders, customers, suppliers, members of local communities, special interest groups, and the like) should be included. Stakeholders are in a position to communicate to the company the risks and opportunities presented to it by, respectively, unethical and ethical behaviour. The extent of internal and external stakeholder engagement in the process of compiling the company’s ethics risk profile will depend on variables, such as numbers, cost, and appropriate research methodologies.

Determining stakeholder perceptions

The purpose of engaging with stakeholders is to gather their perceptions of the company’s ethics performance. Different methods can be used to determine stakeholder perceptions, such as qualitative methodologies (for example, personal or focus-group interviews), quantitative methodologies (for example, questionnaires), or document analyses of internal company documents (for example minutes of meetings or policy documents), media and other reports reflecting the company’s standing amongst its stakeholders.

Ethics risk profile

Having established the ethics perceptions of the company's stakeholders, its ethics risk profile can be drafted. This profile should be reported to the board, enabling it to mitigate negative risks while taking advantage of ethics opportunities. The board needs this ethics profile to develop or revise the company's ethical values and standards.

Code of conduct

The responsibility for developing the code of conduct is that of the board but may be delegated to one of its committees or functional units – for example, the board risk committee, company secretariat, or human resource management. However, once the company's ethical standards have been developed and incorporated in a company code of conduct, the board should endorse and communicate them to internal and relevant external stakeholders (for example, suppliers and customers).

Developing a code of conduct requires a company to consider a number of decisions. The following considerations inform the process of code development.[1]

Purpose of the code of conduct

The purpose served by designing (or revising) a code is intimately linked with the ethics risk profile of a company, its history and culture. On a spectrum of possible purposes, codes can be intended either primarily to *prevent* unethical behaviour, or primarily to *promote* and encourage ethical behaviour, or to balance both these objectives. Moreover, while codes of conduct are usually intended for the company's *internal stakeholders* (board, managers and employees), they might also be intended for identifiable *external stakeholders*, such as suppliers. Thus, apart from being clear about the code's *intended purpose(s)* in the company, it is also important to be clear about the code's *target audience*.

Code of conduct development process

The intended purpose and audience of the code will determine the appropriate code development process. If the primary purpose of the code is to prevent unethical behaviour, the code formulation process will be informed mainly by the *negative ethics risk profile* of the company. If, however, the primary purpose of the code is to promote ethical behaviour, a *consensus-seeking process* is likely to be followed to ensure large-scale buy-in into the proposed standards of behaviour. In the latter case, the process of consultation and consensus-building is almost as important as the final code of conduct that is the outcome of the process. Whether the code is mainly intended for internal stakeholders or external stakeholders will equally

[1] See Deon Rossouw and Leon van Vuuren: *Business ethics* (third edition). Cape Town: Oxford University Press, 2004: 216-222.

have an impact on the process as well as the role-players involved in the process.

Format of the code of conduct

On a spectrum of possible code of conduct formats, the two extremes are directional (rules-based) codes and aspirational (values-based) codes. *Directional* codes are aimed at preventing unethical conduct and consequently tend to be predominantly *rules-based*. They provide specific conduct directives, or specify in detail the behaviours that are acceptable and unacceptable. *Aspirational* codes are intended to promote ethical behaviour. They tend to be predominantly *values-based* and consist of ethical values and principles for guiding the conduct of the company's relevant stakeholders.

Purely or predominantly directional codes tend to undermine personal responsibility, while purely or predominantly aspirational codes tend to be vague or abstract. Consequently, companies often quite sensibly — despite the general directive or aspirational nature of their codes of conduct — opt for *balancing* core ethical values with some illustrative behavioural guidelines, directives or conduct provisions.

In deciding on the appropriate format for a code, the ethics risk profile and the code's intended purpose will be deciding factors. Over time, companies with strong rule-based codes tend to move towards a more value-based code format. To keep a code compact, it is usually supplemented by policies addressing specific ethics matters in circumscribed areas (for example, policies on procurement or safety), with explicit references in the code to those policies.

Content of the code of conduct

The decision on the code's format has direct implications for its content selection. Aspirational codes will focus more on *ethical values* (for, example, honesty, respect, or responsibility), while directional codes will include, besides values, also *behavioural guidelines or prescriptions* (for example, dealing with conflicts of interest, respectful treatment of stakeholders, or gift giving and receiving). Preceding the code, could be a *letter* by the chairman of the board or the CEO demonstrating leadership buy-in by committing themselves personally, as well as the board and executive management, to the code, explaining its rationale, and setting out its purpose, target audience and intended use and applications. Codes can also include possible *sanctions* that will result from transgressing the code, a list of *resources and resource persons* who can assist with interpreting and applying the code, references to ethics-related *communication channels* (including an anonymous *whistle-blowing hotline*), and a list of relevant *policies* related to the code of conduct, if such policies are not already cited throughout the code in appropriate places.

Tone of the code of conduct

Besides its content, a code of conduct communicates an underlying tone (mood or atmosphere). Although often overlooked, it is a vital component of an effective code of conduct. The tone of a code can range from being *prohibitive* (for example, "there will be zero tolerance for…") to *supportive* (for example, "we all aspire to…"). The tone of the code should be closely aligned to the purpose and format of the code. Without due care to strike the appropriate tone, tone and intended purpose may be misaligned, thus undermining the code's effectiveness.

Developing a code of conduct is not a once-off exercise, but an ongoing process. To ensure that the code is attuned to the company's changing ethics risk profile, the code should be revisited regularly and revised when necessary. A well-designed code tends to be resilient to minor changes in the company's ethics risk profile.

Even the best designed code is still merely words on paper. To become effective, it should be ingrained in the company's beliefs, practices and behaviours.

Integrating ethics

The company's ethical standards (code of conduct and related policies) should be integrated into the company's strategies and operations.

Integrating ethical standards into company strategy

Strategically, the board is responsible for institutionalising the company's ethical standards by:

- Assuring that the board itself has adequate ethics expertise, by either appointing individuals with such capacity to the board, or acquiring it through board training and advice;

- Setting ethical objectives and milestones that are integrated into the company's other objectives, in such a way that the strategic importance of ethics is communicated and understood as an integral part of the company's corporate identity and purpose ("who we are") as well as corporate culture ("how we do things");

- Requiring that ethics forms a constituent part of normal business as well as internal and external corporate communication; that ethics informs company policies, procedures, practices, conduct and business agendas; and that all decisions should be preceded by deliberation on ethical issues;

- Communicating a clear message that a failure to meet the company's ethical objectives will undermine the pursuit of its other objectives, and will not be tolerated;

- Tasking the CEO, or an appropriate executive board member, with being the visible link between the board's corporate ethics expectations and the company's ethics management and operations; and

- Providing resources for implementing and operationalising an ethics programme to ensure that the company's internal and external stakeholders understand and live by the company's ethical standards.

Integrating ethical standards into company operations

A company's ethics management strategy can be pursued by means of different operational approaches across a spectrum from values/aspirations to rules/behaviours. (Compare this with balancing the two key constituents of a good company code of ethics, namely, values/aspirations and rules/directives.) Which approach a company chooses in implementing and operationalising its ethical standards would be a function of variables such as its history, developmental stage, size, risk tolerance, current challenges, available resources, and the like.

Operationally, an ethics programme, ideally, has a number of components. However, since an ethics programme's implementation depends on these variables, these components need not — indeed could not — all be put in place at once. Phasing them in properly may take several years. Typical ethics programme components — following an ethics risk assessment and developing a code of conduct — are the following:

- Ethics management *structures* or *offices*, with defined *roles and responsibilities*, could be established:

  - Consideration should be given to having a *board portfolio* responsible for governing the company's strategic commitment to ethical standards and objectives.

  - The responsible board member may chair an *ethics subcommittee of the board* or commission an *institutional/company ethics committee* in which all the company's functions are represented, thus establishing a close link between the board's ethics strategy and operationalising ethics throughout the company.

  - An *ethics office*, headed by an *ethics officer*, should initiate and coordinate operational aspects of the ethics management programme within the parameters set by the board and ethics committee. The ethics officer would act as the operational *custodian* of the ethics management process. Depending on the company's size, an ethics officer may be assisted by other individuals, located throughout the company, serving as *ethics resources* or *ethics champions* in close proximity and accessible to employees on the ground. Again, depending on particular conditions or circumstances in the company, an ethics officer may serve in a *full-time* or *part-time* capacity. Companies need to consider carefully where to *locate* their ethics function from an operational point of view. Whatever the company's decision, of overriding importance is that the ethics office enjoys company-wide *credibility*, and that ethics is understood as *integral* to all company strategies, policies and conduct and not as being confined to a particular function, office, or individual.

- An effective ethics *communication strategy* is central to an ethics programme, and, as such, to ethical risk management. There should be two-way communication on ethics between the company and its internal and external stakeholders, using any of a number of communication channels.

- One such channel of communication is a *whistle-blowing hotline* (as opposed to an advice line) — also called a "safe reporting line" — a confidential or anonymous option for internal and external stakeholders to report legal or ethical misconduct. Anonymous whistle-blowing should be regarded a last avenue for reporting concerns or misconduct after exhausting available line reporting channels. The safety of a whistle-blowing hotline makes it an ideal reporting channel for individuals who fear victimisation. Whistle-blowing may be regarded as undesirable for cultural or historical reasons, but these are outweighed by the need to prevent and detect misconduct in the interest of all company stakeholders.

- Ethics *training* is the responsibility of the ethics office in cooperation with the company's other training functions. Such training should be at induction as well as ongoing. It may have different objectives according to the target groups — such as training to raise general ethics awareness, build managerial competence, or equip specialist groups. The code of conduct, more specifically its values component or statement, should be the point of departure of ethics training. Ethics training should include the purpose and mechanics of safe reporting (whistle-blowing) and ethics advice channels. Importantly, every training initiative on all policies and procedures should be based on ethics.

- A company's *conflict resolution* mechanisms should make provision for resolving ethical dilemmas. Forums and mechanisms for resolving complex ethical dilemmas should be designed. Members of the company should have ready access to these forums or mechanisms and should be trained to use them effectively.

Reporting and disclosure

Reporting principles are discussed in Chapter 9, "Integrated sustainability reporting and disclosure" of the King Report on Governance for South Africa. When companies disclose their specifically *ethics* performance, these *general* reporting principles apply.

More *specific* practice guidelines for both internal and external assessment, reporting on and disclosure of specifically *ethics* performance can be added to these general reporting principles of chapter 9.

Internal ethics reporting, disclosure and assessment

The *ethics office* (or person responsible for ethics management) takes responsibility for *reporting internally* to management on the company's ethics performance and *disclosing* the information in a formal, written internal ethics report.

The *internal audit function* is responsible for assessing the ethical culture of the company as well as the adequacy and effectiveness of the ethics programme of the company.

The *process* of internal reporting, disclosure and assessment involves the following:

- The *ethics office* (or body responsible for ethics management) should:
    - Report internally on the ethics performance of the company to management; and
    - Disclose the information in a formal, written internal ethics report to management. Disclosed information could specifically include details of:
        - The ethics risk identification and assessment process;
        - The code of conduct – where it could be obtained; development process, revision process and institutionalisation process;
        - All ethics related policies and procedures – gifts and entertainment policy, declaration of interests policy, ethics training policy;
        - Steps taken to combat misconduct, for example, fraud and corruption;
        - Reporting mechanisms in place to report on unethical conduct;
        - Rewarding ethical behaviour and disciplinary actions taken against unethical behaviour; and
        - Any other ethics interventions or initiatives.
- The *internal audit function* should follow an integrated approach to assess the quality of ethics performance by:
    - Considering the effectiveness of the ethics strategy of the company;
    - Evaluating and assessing the ethics risks attached to the ethics strategy;
    - Evaluating the adequacy and effectiveness of specific controls implemented by the ethics office to address the risks for example ethics structures, policies and procedures, whistle-

   blowing channels, personnel practices, communication strategies, conflict resolution and ethics training;
   - Testing compliance to specific ethics policies and procedures;
   - Evaluating the efficiency and effectiveness of all ethics initiatives in achieving ethics objectives;
   - Evaluating the outcomes of all ethics initiatives;
   - Identifying weaknesses in formal and informal systems and processes;
   - Making recommendations to senior management and the board for improving the ethical culture and ethics programme; and
   - Presenting its findings in an internal ethics audit report to senior management, the board, and audit committee (in line with the IIA standards[2]).

External assessment, reporting and disclosure

As part of its integrated reporting, the board reports on the company's ethics performance and discloses the information in a sustainability report. The independent external assessor takes responsibility for independently verifying the *effectiveness* of the systems and processes underpinning the ethics performance of the company as well as verifying the *information* provided in the integrated report. The independent external assessor then issues an *assurance statement* to provide independent assurance on the quality of ethics performance and confirms that the information provided in the report is in line with the relevant reporting principles.

The *process* of external assessment, reporting and disclosure involves the following:

- Independent verification of the *effectiveness* of the company's ethics performance – the independent external assessor should:

   - Apply a clear set of principles and standards for evaluating the quality of the company's ethics performance;
   - Evaluate the achievement of ethics objectives as well as the outcomes of all ethics interventions; and
   - Consider the extent to which the work of the internal audit function, with regard to the internal assessment of ethics performance, can be relied upon.

- Independent verification of the *information* provided by the board according to generally accepted auditing practice for all reports provided by the board – the independent external assessor should:

   - Express an opinion on:

      - The effectiveness of the ethics performance of the company; and

[2] *The International Standards for the Professional Practice of Internal Auditing*, by The Institute of Internal Auditors (IIA). See www.theiia.org.

- The reliability of the information provided by the board; and

  - Present the opinion in a formal, written *assurance statement* (included in the sustainability report).

Reporting externally on the ethics performance of the company by disclosing verified information in a *sustainability report*.