

Institutional investors believe that better financial performance is achieved through better management, and better managers pay attention to governance, hence the company is more attractive to such investors.

Good governance is not something that exists separately from the law and it is entirely inappropriate to unhinge governance from the law. As far as the body of legislation that applies to a company is concerned, corporate governance mainly involves the establishment of structures and processes, with appropriate checks and balances that enable directors to discharge their fiduciary responsibilities, and oversee compliance with legislation. In addition to compliance with legislation, the criteria of good governance, governance codes and guidelines will be relevant to determine what is regarded as an appropriate standard of conduct for directors.

The more established certain governance practices become, the more likely a court would regard conduct that conforms with these practices as meeting the required standard of care. Corporate governance practices, codes and guidelines therefore lift the bar of what are regarded as appropriate standards of conduct. Consequently, any failure to meet a recognised standard of governance, albeit not legislated, may render a board or individual director liable at law.

The next chapter explores the overview, strengths and potential obstacles of South African SOEs by giving specific attention to the role of the state as a shareholder and a manager of its assets.

CHAPTER THREE

AN OVERVIEW OF SOUTH AFRICAN STATE–OWNED ENTERPRISES

“There must be significant role for public sector investment to complement private sector and community participation in stimulating reconstruction and development. The primary question in this regard is not the legal form that government involvement in activity might take at a given point, but whether such actions strengthen the ability of the economy to respond to the inequalities in the country, relieve the material hardship of the majority of the people, and stimulate economic growth and competitiveness.”¹³³

3.1 Introduction

The management efficiency of SOEs is being widely discussed both nationally and internationally. This chapter attempts to explain the state of South African SOEs from the perspective of corporate governance reforms and the government’s master plan to improve the situation.

Interesting to this chapter as well is the discussions around the establishment and role of SOEs, performance that influenced changes of the SOEs, the model describing the change of these SOEs. The adaptation of corporate governance principles and take-over of the leading practices based on the approach of historical institutionalism and a potential improvement of management efficiency, related to implementation of the principles of corporate governance will also be explored. Potential obstacles and strengths of SOEs are also discussed in this chapter. Specific attention is also given to the role of the state as a shareholder and a manager of its assets. Focusing on the question of management efficiency, attempts to justify and explain the role of SOEs in the development of national economy will be analysed to find an evidence of positive effects related to the implementation of corporate governance principles.

Four SOEs that were established since 1920 that is Escom, Iscor; Sasol and Foscor which have or had a responsibility of infrastructure improvements and the supply of basic materials have been selected as a case study in this research to determine the patterns of cause and the effect that determined the processes of corporate governance reforms

¹³³ ANC Reconstruction and Development Programme (1994)

3.2 Establishment and role of Eskom, Iscor, Sasol and Foskor

By the early 1920s, the Government of South Africa was concerned about the lack of standardisation in the power industry and the need to expand capacity to support the electrification of the railways and accelerated industrialization.¹³⁴ Merz and McLellan, were commissioned to examine the general question of electricity supply in South Africa.¹³⁵ They recommended the need to have a central controlling authority to oversee and coordinate the development of the electricity industry. The government responded with the Electricity Act, No 42 of 1922, which made provision for the establishment of the publicly owned Electricity Supply Commission (Escom). Escom was given statutory powers to establish distribution undertakings in cooperation with the existing generators to ensure a cheap and abundant supply of electricity.¹³⁶ The Electricity Act of 1922 also provided for the establishment of the Electricity Control Board (ECB) to regulate electricity supply and issue licences. After the 1973 oil crises, diesel and oil-fired generators of municipalities were uncompetitive and the energy users switched to electricity as other fossil fuels became very expensive.¹³⁷ Electricity demand levels soared higher than ever before. The utility was forced to rapidly increase plant orders and to increase prices by 70 per cent between 1974 and 1978.¹³⁸

In the 1990s, further changes were fuelled by the democratic revolution that marked the end of the apartheid era in South Africa. A massive electrification programme was initiated and the proportion of the population with access to electricity increased from one-third to over two-thirds. The Eskom Conversion Bill of 2001 replaced the old Eskom Act of 1987 with subsequent amendments. Eskom was converted into a public company (named Eskom Holdings Ltd) with its share capital held by the state. It now paid taxes and dividends.¹³⁹ A memorandum to the Bill described its purpose as bringing about more efficiency and competitiveness in the running of Eskom, exposing Eskom to global trends and ensuring that Eskom is run in terms of a

¹³⁴Eberhard A & Mtepa M 'Rational for restructuring and regulation of a 'low priced' public utility: a case study of Eskom South Africa' (2005)*International Journal of Regulation and Governance* 77'

¹³⁵Eberhard A & Mtepa M 'Rational for restructuring and regulation of a 'low priced' public utility: a case study of Eskom South Africa' (2005)*International Journal of Regulation and Governance* 77'

¹³⁶Mallin C A *International Corporate Governance: A Case Study Approach* (2006) 285

¹³⁷Steyn G Eskom: are we missing the opportunity to learn from history? <http://www.gsb.uct.ac/mir> (accessed on 06 October 2015)

¹³⁸Steyn G Eskom: are we missing the opportunity to learn from history? <http://www.gsb.uct.ac/mir>(accessed on 06 October 2015)

¹³⁹McDonald D *Electric Capitalism: Recolonising Africa on the Power Grid* (2001) 64

protocol on cooperative governance.¹⁴⁰ The board of directors was then established to provide strategic direction and was answerable to the state and the executive management was then responsible for the day to day running of the company.¹⁴¹

In executing their mandate the executive management warned both the board and the government in the late 1990s that Eskom would run out of power reserves by 2007 unless action was taken to prevent it.¹⁴² The advice was ignored Eskom was marked by power shortages, severe financial losses and electricity price rises that pushed up South Africa's inflation rate under the leadership of Mr Jacob Maroga who was the Chief Executive Officer of Eskom.¹⁴³ Government failed to heed on the said warnings as a result failed to respond to the forecasts given by Eskom. The question remains, was there any lack of capacity and expertise necessary for this level of corporate governance by the government oversight committee. Nor is the board of Eskom free of blame, for it is their duty not just to inform Government but also to take every measure to make sure they are heard.¹⁴⁴

The government oversight committee's role of oversight in management the potential risk was critical in ensuring that Eskom takes the adequate steps to prevent, and prepare for, the harms that can result from such negative decision making processes. There is no substitution for proper preparation, deliberation, and engagement on matters of such national interest. Lessons learnt from these rapidly evolving risks include that both the directors and government oversight committee should take seriously their obligation to make sure that companies are appropriately addressing those risks.

The *OECD Guidelines* highlighted some of the main challenges affecting SOEs which are, limited autonomy as a result of political interference, major threats of takeover and bankruptcy, diluting accountability and undermining SOEs's financial discipline. Accountability is diluted by the complex chain of government ownership which can be exercised through many different governmental entities with differing

¹⁴⁰McDonald D (2001) 64

¹⁴¹ Khoza R J and Mohamed Adam M *The Power Of Governance, Enhancing the Performance of State-Owned Enterprises* (2007)8

¹⁴² Terblanche S State- Owned Enterprise, Telkom Latest Casualty amongst troubled SOEs published 12 November 2012 on Leadership Magazine

¹⁴³ Terblanche S State- Owned Enterprise, Telkom Latest Casualty amongst troubled SOEs published 12 November 2012 on Leadership Magazine

¹⁴⁴ McGregor L *Improving Corporate Governance in South Africa* (2008) 8

priorities, such as Parliamentary review committees, the President's office, Ministry of Finance, sectoral ministries and state audit agencies.¹⁴⁵

What Eskom board of directors needed in that case was full autonomy to exercise their full responsibility and the authority required to give strategic guidance without fear or favour. Not only that, the boards also needed to feel empowered to fulfil their duties and be capable of giving objective and independent judgment. This means that, they should not act as individual representatives of the constituencies that nominated them. That also implies that mechanisms must be established to protect them from undue political interference, which could detract them from carrying out their duties in the interest of the company and its shareholders. This should be viewed as a way for the directors to add value and enhance corporate performance rather than to exercise a controller's function on behalf of the state. In order to fulfil this, boards should act as collegial bodies, and most specifically not act as representatives of specific interests.¹⁴⁶

This was supported by Shirley when he stated that good performance will only happen when political influence with boards is restrained so that the boards are held more accountable.¹⁴⁷ Most successful SOEs have a balance of public and private interests and are commercially run without political interference. This was echoed by Goldman Sachs MD Colin Coleman when he was addressing the Super Return Africa Private Equity & Venture Capital Conference. He said in his address that South Africa should follow the Chinese example by modernising its state-owned enterprises (SOEs) as its current model is no longer working and can no longer be financed. He continues further to say that the Chinese government raised about \$120bn through the flotation of state-owned companies over a 30-year period while retaining a controlling stake in them. This gave rise to a new era of high performing companies and unleashed the infrastructure programmes so essential to Chinese growth and development. He concluded by saying that what was not needed, however, was continued political meddling in SOEs.¹⁴⁸

¹⁴⁵ OECD *Ownership oversight and board practices for Latin American State Owned Enterprises* (2001) 4

¹⁴⁶ OECD *Guidelines on the Governance of State Owned Enterprise for Southern Africa* (2014)30

¹⁴⁷ Shirley, M 'Why Performance Contracts for State Owned Enterprises Haven't Worked' (1998) 150 *World Bank, Policy* 120

¹⁴⁸ Ensor L SA's 'State-owned enterprises situation of serious concern' *Business day* 04 December 2014 3

Iscor, another state company was established in terms of the Iron and Steel Industry Act, 1928 No. 11 of 1928. The objectives of establishing the company were, to produce iron and to create employment opportunities.¹⁴⁹ The result of that decision brought about the erection of a plate mill at *Vanderbijlpark*. Works was commissioned in 1943 mainly for the production of heavy plate for ship repairs and the manufacture of armoured cars for South Africa's war effort. Directly after the war, it was decided to build a fully integrated steel works at *Vanderbijlpark*, and a start was made on this early in 1947. Iscor started trading in 1947. The enactment of the Companies Act of 1973 led Iscor to adopt a more corporate organization that allowed it to be run in the manner of a private company. Nonetheless, Iscor remained a state-owned firm until the late 1980s, enjoying its dominant position with up to 85 percent of the domestic steel market under its control and protectionist trade policies.¹⁵⁰

In 1985 privatisation was accepted as part of the economic policy in South Africa for economic development. Loane Sharp writes that even though privatisation was key to real economic transformation it nevertheless should be seen as a means to adopt an economic stance that is reliant on a simple dichotomy, narrowing the analytical framework to the conflict between the state and the market.¹⁵¹ His assessment of privatisation largely overlooks evidence that favours state economic intervention.

According to the national government, Iscor never lived up to the expectations of its master as most of its plants reached their limit of growth. The local and world demand of steel also reached its lowest levels. As a result of economic crisis the state company did not generate any economic growth and competitiveness. There was no need to reform the management of the company hence the decision to privatise was credible enough.¹⁵²

In 1950 the government appointed a committee to investigate all aspects of producing oil from coal.¹⁵³ The recommendation of the committee leads to the establishment of a State-owned company which was formed to take over the Anglovaal venture. The committee recommended that the plant be based on the Fischer-Tropsch process, employing German reactors to produce diesel fuel,

¹⁴⁹ Dr Hendrik Johannes van der Bijl an electrical engineer and industrialist who was the chairman of Iscor in 1941

¹⁵⁰ International Directory of Company Histories, Vol. 57. St. James Press, 2004 <http://www.iscor.com> (accessed 06 October 2015)

¹⁵¹ Sharp L 'Privatisation is key to real economic transformation' *Business Day* 17 September 2014 16

¹⁵² International Directory of Company Histories, Vol. 57. St. James Press, 2004 <http://www.iscor.com> (accessed 06 October 2015)

¹⁵³ Mind over matters: Petrochemical , where did it all start. <http://www.sasol.com> (Accessed 15 August 2015)

lubricants, chemicals and waxes, and the plant designed by the Kellogg Corporation to produce petrol.¹⁵⁴

Government accepted these recommendations. In September 1950, Sasol was formally incorporated as a State-owned company under the unwieldy name of the South African Coal, Oil and Gas Corporation (Sasol). Its directors were appointed either directly by the government or by the parastatal Industrial Development Corporation (IDC), through which the government channelled capital for the enterprise. It took South Africa down an increasingly lonely road as world disapproval of apartheid deepened. It also, however, demanded that South African industry develop its own skills and production capability, rather than rely on overseas experts and factories. Industrialists responded enthusiastically; Sasol was not an isolated case of courageously taking on the unknown. What distinguished Sasol from other South African adventurers was that it set out to create an industry that existed nowhere else in the world.¹⁵⁵

In the 1970s when the oil crisis drove up oil prices, the increasingly isolated apartheid state considered energy security a priority and instructed Sasol to build two more CTL plants. Construction was 'fast-tracked' when the Shah of Iran, a key ally and South Africa's largest supplier of crude oil, was overthrown.¹⁵⁶ Although privatised in 1979, Sasol remained close to the state both before and after the political transition to majority rule with the state-owned Industrial Development Corporation (IDC) retaining a major shareholding.¹⁵⁷

In 1990 South Africa went through two major changes, one was the end of white supremacy and the other had to do with international trade and tariff barriers. Industries that had previously been heavily protected against imports by the Nationalist government, under its policy of promoting economic diversification, were suddenly exposed to the bracing wind of international competition.¹⁵⁸

The link between Sasol and the state remains tight. The state portrays Sasol as a paragon of innovation and hence as a key national asset for industrial development.

¹⁵⁴ Mind over matters: Petrochemical , where did it all start: <http://www.sasol.com> (Accessed 15 August 2015)

¹⁵⁵ Collings J Mind over matter, the Sasol Story: A half-century of technological innovation : <http://www.sasol.com> (Accessed 10 June 2015)

¹⁵⁶ FOE *Sasol and South Africa's climate policy* (December 2011)3:[http:// www.foei.org/wp./Sasol-Report-2](http://www.foei.org/wp./Sasol-Report-2) (Accessed 10 June 2015)

¹⁵⁷ FOE *Sasol and South Africa's climate policy* (December 2011)3

¹⁵⁸ Sasol Annual Report 2013

It has become a global technology leader, linked into global production networks through partnerships with a range of leading transnational and state-owned corporations.¹⁵⁹ Sasol's power as a key supplier of energy in South Africa, and its historically close ties to government, have given it a privileged position, allowing it to influence government, not only at a national level, but also globally. It uses this position to promote what it sees as profitable opportunities created by climate change, while working to protect its core business interests, profiting from dirty fossil fuels.¹⁶⁰

Sasol applies sound corporate governance structures and processes, which the board considers pivotal to delivering sustainable growth in the interests of all stakeholders. Sasol's values-driven culture and code of ethics underpin its governance structures and processes, committing the company to high standards of business integrity and ethics in all its activities. Governance structures and processes are reviewed regularly, and adapted to accommodate internal developments and reflect national and international best practice.¹⁶¹ Sasol is a good example of a company that has implemented controls to provide reasonable assurance of its compliance with all relevant requirements in respect of its listings.

After the Second World War, the possibility of phosphate mining was investigated as a matter of strategic importance.¹⁶² Eventually, in 1951 the State acquired the necessary claims from Dr Merensky, and the Industrial Development Corporation (IDC) established the *Unie-Fosfaat-Ontginningsmaatskappy (Eiendoms) Beperk* to develop the deposit. A few years later the name was changed to the Phosphate Development Corporation Limited and in 1987 to Foskor Limited. Production started in 1954 under difficult conditions and the scale of mining operation was too small to be economic.¹⁶³

Currently, Foskor's Board of Directors is responsible to its shareholders for the performance of the company. Its role includes the establishment, review and

¹⁵⁹ Sasol Annual Report 2013

¹⁶⁰ FOE *Sasol and South Africa's climate policy* (December 2011)6:[http:// www.foei.org/wp./Sasol-Report-2](http://www.foei.org/wp./Sasol-Report-2) (Accessed 10 June 2015

¹⁶¹ Sasol Annual Report 2013

¹⁶² Roux E H , De Jager D H, Du Plooy D H , Nicotra A, Van Der Linde G J & D E Waal *Phosphate in South Africa J.S. Afri. Inst. Min. Metall*, vol 89 no. 5 (1989) 129-139

¹⁶³ Roux E H , De Jager D H, Du Plooy D H , Nicotra A, Van Der Linde G J & D E Waal *Phosphate in South Africa J.S. Afri. Inst. Min. Metall*, vol 89 no. 5 (1989) 129-139

monitoring of strategic objectives, approval of major acquisitions, disposals and capital expenditure, and overseeing the Group's systems of internal control, governance and risk management.¹⁶⁴The Board takes overall responsibility for Foskor's success. Its role is to exercise leadership and sound judgement in directing the Group to achieve sustainable growth and to act in the best interests of stakeholders.¹⁶⁵

The Board retains full and effective control over the company by monitoring the executives in their implementation of Board policies and strategies, as well as by setting targets and measuring the company's performance on an annual basis. The Board is also responsible for ensuring compliance with all relevant laws, regulations and codes. The Board Committees assist the Board in executing its duties and exercising its powers. The Board delegates to each committee the authority required to enable it to fulfil its functions through formal Board-approved terms of reference. The Board does not discharge its responsibility by delegating its authority to the Board Committees.¹⁶⁶

3.3 The situation analysis of the performance of existing SOEs

The performance of SOEs operations has been reflected in their financial reports. The financial reports are used to compute data which reflects the performance to be evaluated by the stakeholders. The concern over their performance now comes at a time when government is experiencing a social and financial crisis and some of the SOEs have become obstacles to the resolution of macro-economic problem. The situation is serious in that government has called for a review of their mandate.¹⁶⁷

Adele Thomas reported incidences of corporate governance transgressions at five strategic SOEs. Transgressions for each SOE were documented against the Organisation for Economic Co-operation and Development's framework of best practice in governance for SOEs by reviewing annual reports and newspaper article citations over a two-year period.¹⁶⁸

¹⁶⁴ Foskor Annual Report 2013

¹⁶⁵ Foskor Annual report 2013

¹⁶⁶ Foskor Annual report 2013

¹⁶⁷ De Vos D 'Analysis: The crisis at Eskom, a dry run for South Africa itself.' *Daily Maverick* 25 March 2015

¹⁶⁸ Thomas A 'Incidences of corporate governance transgressions at five strategic'(2012) 8 *Social Responsibility Journal* 448

Such transgressions include:

- a) Poor leadership, evident in conflict between the Chairman and CEO, senior leadership vacancies and a lack of succession planning, instability in executive leadership, delays in senior appointments and political appointments and cronyism,
- b) Inappropriate rewards including excessive pay and benefits to executive managers and board members in spite of SOE underperformance,
- c) Mismanagement of resources evident in poor long-term strategy development, poor financial accountability and fruitless or wasteful expenditure and
- d) Board irregularities demonstrated in apathy or ignorance of company affairs, irregular attendance at meetings and excessive concurrent board appointments, lack of adherence to fiduciary duties, bribery and corruption, conflicts of interest, tender-rigging, and lack of regular board appraisal.¹⁶⁹

Her findings were that, while political intervention in the operational running of each SOE is apparent, government appears not to have fulfilled its oversight role of ensuring the sound governance of SOEs according to best practices.¹⁷⁰ These incidences themselves demonstrate that lax regulatory institutions, standards, and enforcement can have huge implications for the economy and for the public.

These concerns over South African SOEs corporate governance standards are so clear that the status quo is no longer acceptable. The low productivity growth of SOEs, low profitability and increasing losses and fiscal subsidies to loss making are an ongoing problem. It will not help government to inject massive amounts of capital into these ailing SOEs without proper interventions. The creation of a modern enterprise system a diversified form of ownership that would compete on equal terms

¹⁶⁹Thomas A incidences of corporate governance transgressions at five strategic (2012) vol 8 *Social Responsibility Journal* 450

¹⁷⁰ Thomas A incidences of corporate governance transgressions at five strategic (2012) vol 8 *Social Responsibility Journal* 455

in the market place may assist South Africa. Government could benefit from articulating a plan that will/should include the following¹⁷¹:

- (a) limiting the scope and size of traditional state enterprises.
- (b) Some of the small SOEs being converted into non-state owned enterprises.
- (c) Encouraging some SOEs to merge and labour forces to be redeployed, and
- (d) Transforming ailing SOEs into autonomous commercial institutions.

3.4 The role of the state as shareholder

The lack of any real comprehensive legislative definition of national or provincial state owned entities in our statute books is another challenge. The State's ownership interest in SOEs is represented by Government through different institutions: Shareholder Minister/ Municipalities. Currently in South Africa there are three spheres of Government and those are the national, provincial and local government. All Government spheres with the exception of local government have the power to create statutes,¹⁷² and it is through these statutes that most, if not all these institutions have established SOEs through which some of the programmes of these Government institutions are driven. These statutes are referred to as founding Acts/ legislation of these public entities. Over and above these founding Acts there are other laws that apply to SOEs.

Currently there are over 300 publicly owned SOEs across all levels of government. The eight major public companies are under the oversight of the Department of Public Enterprises (DPE), and one of them being Telkom is listed on the Johannesburg Stock Exchange (JSE) which is under the oversight of the Department of Communications. At the sub-national level a number of SOEs and parastatals are active in a broad range of activities, of both a commercial and non-commercial nature. The economic importance of SOEs is concentrated in the top 30 companies,

¹⁷¹ Lardy N R *China's Unfinished Economic Revolution* (1998) 24

¹⁷² Section 104(1)(b) of the South African Constitution, 1996

with four accounting for 91 per cent of the assets, 86 per cent turnover, and 77 per cent of SOE employment.¹⁷³

South African corporate governance with regard to SOE's is applied through the precepts of the Public Finance Management Act (PFMA) which encapsulates the principles contained in the King Reports on Corporate Governance. Governance oversight over SOEs vests in the Boards of SOEs, the Executive and Parliament.

(a) The Board of Directors :

The Board of Directors of SOEs is the governing body of the SOEs. The Board has absolute responsibility for the performance of the SOEs and is fully accountable for the performance of the SOEs. Governance principles regarding the role and responsibility of SOEs Boards are contained in the PFMA and the Protocol on Corporate Governance.

King III recommends that the Board should have an approved Charter that sets out the roles, duties and responsibilities of the Board as well as salient corporate governance principles. The role of the Board should include amongst other things the following activities:

- Providing strategic direction and leadership;
- Determining the goals and objectives of the company;
- Approving key policies including investment and risk management;
- Reviewing the company's goals and strategies for achieving its objectives;
- Approving and monitoring compliance with corporate plans, financial plans and budgets;
- Reviewing and approving the company's financial objectives, plans and expenditure;
- Considering and approving the annual financial statements and notices to the shareholder;

¹⁷³ A Thomas 'Governance at South African state-owned enterprises: what do annual reports and the print media tell us?' (2012), *Social Responsibility Journal*, Vol. 8 Iss: 4, p.448

- Ensuring good corporate governance and ethics;
- Ensuring that the Shareholder's performance objectives are achieved and that this can be measured in terms of the performance of the SOEs;
- Ensures that the SOEs complies with and is operating in accordance with all applicable laws, regulations, government policies and codes of good business practice, regulations and instructions prescribed in terms of legislation;

(b) Departments :

SOE's are entities through which the Executive Authority delivers services. In Most cases the departmental targets would incorporate the service delivery targets of SOE's that report to their Executive Authorities. The annual shareholders' compact serves as the agreements between the SOE and the Executive Authority to deliver on their mandate.¹⁷⁴

(c) The Auditor-General:

The Auditor-General is a state institution accountable to the National Assembly. Section 188 of the Constitution provides that the Auditor-General must audit and report on the accounts, financial statements and financial management of all national and provincial departments, all municipalities and any other institution or accounting entity required by national and provincial legislation.

(d) The Executive Authority :

The Executive Authority which is the Minister of the respective ministry acts as shareholder, while the Minister of Finance and the National Treasury is responsible for financial oversight. The PFMA gives authority to the Executive Authority for oversight powers with particular reference to the corporate plans, shareholder's compacts and quarterly reports. The Executive Authority also has the power to appoint and dismiss the Board of SOEs. It must also ensure that the appropriate mix of executive and non-executive directors is appointed and that directors have the necessary skills to guide the SOEs.

¹⁷⁴ Governance Oversight Role Over State Owned Entities (Soe's) <http://www.treasury.gov.za> (accessed on 15 August 2015)

The Executive Authority's corporate governance responsibility as shareholder, involves ensuring that, from the Board of directors downwards, and also in respect of accountability of the Board upwards to the shareholder, all the necessary and appropriate corporate governance structures, procedures, practices, controls and safeguards are established, properly implemented and operate effectively in the SOEs concerned.¹⁷⁵

(e) Parliament :

Parliament exercises its role through evaluating the performance of SOEs by interrogating their annual financial statements. Section 42(3) of the Constitution empowers the National Assembly with the power to scrutinise and oversee the executive action. Section 65 of the PFMA requires the executive authority responsible for a public entity must table in the National Assembly or a provincial legislature, as may be appropriate— (a) the annual report and financial statements referred to in section 40 (1) (d) or 55 (1) (d) and the audit report on those statements, within one month after the accounting officer for the accounting authority for the public entity received the audit report;

3.5 Conclusion

Acknowledging that the South African SOEs have operated within a number of operational constraints, a number of improvements could be made. Full executive autonomy without political interference, non-conflicting objectives, and organisational reform are essential for efficient performance. What could assist South African SOEs is the development of explicit plans so that board of directors and executives of such SOEs know what is expected of them. Those plans could include economic, social, environmental and financial objectives. If executives are given the authority to achieve these objectives subject to reporting and monitoring mechanisms being put in place, an appropriate reward and sanction mechanisms should be established to

¹⁷⁵ Governance Oversight Role Over State Owned Entities (Soe's) <http://www.treasury.gov.za> (accessed on 15 August 2015)

enforce good performance. Emphasis should also be given to improving the quality of management within the SOEs, rather than resorting to alter the organisational forms. Management skills should be enhanced through the appointment of successful private sector experts serving on the Boards' Advisory Committees.

Full and proper implementation of corporate governance principles can serve as a positive influence on SOEs' management efficacy. Management transparency when properly employed will potentially increase the involvement of society into the process of SOEs management and thus have a positive pressure on the executives of SOEs to improve the management principles of appropriate organizations

Financial objectives alone are an insufficient basis for evaluating the performance of SOEs the key concern should be efficient management in the face of imperfect competition. Social objectives and the traditional values of the public service should not be lost in the pursuit of financial objectives. Ministers have a range of social, economic, political, and financial objectives as owners of state owned enterprises.

In conclusion, in order to have a viable and competitive SOEs, SOEs need to adopt the longer term views of sustainability which encompass numerous stakeholders, rather than simply trying to maximise profits. In response to the failings of the current SOEs model for trading activities, the recommendation is that the primary aim of the State should be to act as an informed and active owner and establish a clear and consistent ownership policy, ensuring that the governance of SOEs is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness.¹⁷⁶ The second recommendation is for an acceptance of an overall set of principles to guide the reform of individual commercial SOEs. The third recommendation is a determination of a comprehensive review of each State Owned Enterprise so that a programme of adjustment is consistent with the approved principles. Separating commercial and non-commercial entities can increase performance against target rates of return.

¹⁷⁶ OECD *The Evolution of State Owned Enterprises in South Africa* (2012) Paris

Compliance as a measure for corporate governance is another tool to be used in assessing governance frameworks, practices and behaviours against outlined rules, regulations and principles and the said is fully discussed in the next chapter.



CHAPTER FOUR

MEASURING THE EFFECTIVENESS OF CORPORATE GOVERNANCE

"in today's climate of current disclosure and fairness, there's no room for executives to cut corners...executives must certify that the information is correct' when they sign their company's (SEC) filings...if their statements contain material misstatements or omissions, they can be exposed not only to civil penalties and lawsuits, but also to criminal prosecution and prison"¹⁷⁷

4.1 Introduction

The essence of good corporate governance is to ensure that across the organisation, all laws and regulations are complied with. This basically requires the board to develop effective standards of corporate governance; establish effective business systems, financial controls and risk identification and management processes. The board must also ensure proper stewardship of the company and hold themselves accountable to the company's shareholders. Within the corporate structures the role of the board of directors remains crucial. The tone at the top determines the tune in the middle.

Existence of appropriate values and standards of business conduct which includes transparency, responsibility, fairness and effectiveness throughout the organisation breeds good corporate governance and as such nurtures a culture of accountability. Good corporate governance involves a lot more of compliance as such this chapter covers the compliance levels, the factors that influence the level of compliance of corporate governance, international perspective and South African perspective on compliance.

4.2. Compliance levels

Corporate governance is multi-faceted in nature and encompasses company law, the regulatory framework, the Listing Rules, the King Codes on Corporate Governance, ethical standards, corporate strategy and government policy. Obviously, failure to comply with any one of these areas will impact on the perception of corporate governance standards. Good corporate governance, however, is more than a set of

¹⁷⁷ Honorable Alfred J. Lenchner JR (USA)

rules or a code; it is a state of mind and a culture that needs to be embedded from government right through to corporate level.¹⁷⁸

The main principle of compliance is for the board to have a balance of skills, experience and diversity of perspectives appropriate to the requirements of the business they lead. The board should ensure that changes to its composition can be managed without undue disruption. There should be a balance on the composition of executive and non-executive directors including independent non-executive directors so that there is a strong independent element on the board, which can effectively exercise independent judgement.¹⁷⁹

There is certainly a demand for accountability and responsibility in corporate behaviour. Even though it will take more than just leadership to restore public confidence in South African SOEs in order to ensure their ongoing vitality, effective government action in the form of robust monitoring or oversight role, independence of auditing system, and stepped up law enforcement is needed. Regulatory reforms that over-react or address symptoms while ignoring underlying causes can be costly and counter-productive. Government's task is to restore corporate integrity and market confidence without stifling the vitality that underlies a strong economy.¹⁸⁰

Dalton and Dalton's discovery on compliance level is that in spite of increasing legislative measures, there is little evidence that the governance of South African SOEs has improved over time. They attribute the lack of progress to a misplaced focus where structural aspects of the board of directors for example composition of the board and of board committees, CEO/Chairman structure, board size dominate over process issues that relate to the tone of the culture and to many of the subtle issues that are difficult to clearly measure.¹⁸¹ Highly effective boards include a mix of directors with the expertise and experience to fulfill their essential oversight roles. Having a board made up of the right people with the relevant skill sets is critical in today's competitive business environment.

¹⁷⁸ Arun T & Turner J *Corporate Governance and Development Reform, Financial Systems and legal Framework* (2009)23

¹⁷⁹ Corporate Governance Code And Corporate Governance Report <https://www.hkex.com> (accessed on 16 August 2015)

¹⁸⁰ Corporate Governance Code And Corporate Governance Report <https://www.hkex.com> (accessed on 16 August 2015)

¹⁸¹ Dalton C M & Dalton D R *Corporate governance best practices: the proof is in the process* (2006). 5

Another point that could assist the board in exercising its fiduciary responsibility without fear and undue pressure is their sound judgment as guided by integrity, observation, experience, insight, and institutional policy. It is not enough to protect the institution's wealth, the board members should also take cognizance of looking to the future and execute their duties with loyalty, faith and trust. They must ensure commitment to mission, integrity of operations, and conservation of core values; and they must safeguard the institution's moral compass. Board members should be substantively educated on the institution's mission, programs, finances, and challenges. They should be open-minded, reflective, and not be narrow-minded.

Lynn McGregor's findings support the study in the sense that most board members do not meet the traditional definition of independence due to the nature of their appointment.¹⁸² That has as such caused compliance level to go down. She attributes the problem of the level of compliance with corporate governance structure which hinges on the independence of directors, who are supposed to bring objectivity to the oversight function of the board and improve its effectiveness. The problem is that independent directors cannot play an effective role in isolation despite their commitment to ethical practices nor stop a decision that is detrimental to the members individually, but if they act collectively, they will be able to act prudently before arriving at any such decision.¹⁸³ Independent directors may not be in a position to stop fraud at the highest level, but with a high level of commitment and due-diligence they are well placed to identify signals that indicate that everything is not as it should be.¹⁸⁴

Dalton and Dalton also suggest that while structure is a prerequisite for board effectiveness, it is not sufficient by itself to ensure board success process and systems are also important elements for the success of good corporate governance.¹⁸⁵ Matthew Harris's views concurred with the said views in that 'adequate system and processes are of vital importance for a company that wishes to sustain a high level of Corporate Governance.'¹⁸⁶ He further contends that there is an inappreciative amount of reliance on them in the modern day workplace and

¹⁸² McGregor L *Rating corporate governance of state owned enterprises report*. (2012) para 1

¹⁸³ McGregor L (2012) para 2

¹⁸⁴ McGregor L (2012) para 1

¹⁸⁵ Dalton C M & Dalton D R *Corporate governance best practices: the proof is in the process* (2006). 5

¹⁸⁶ Harris M 'Systems and processes in Corporate Governance to the applied corporate Governance' <http://www.Committeewise.com> (accessed on 03 August 2015)

these requires a demand for more control mechanisms, better communication and improved systems to drive efficiency.¹⁸⁷

Disclosure is one of the essential factors that can influence compliance level. It provides for the base for informed decision-making by shareholders, stakeholders and potential investors in relation to capital allocation, corporate transactions and financial performance monitoring.¹⁸⁸ Management or the executives have as a matter of course a very critical role to play in the day-to-day operation of the company which includes amongst others the disclosure of material information on the financial and operating results of the company, company objectives and foreseeable risk factors to the board. The execution of strategies, policies, processes, and procedures that have been established by the board ought to be reported to indicate a compliance level.

The Cadbury Report added three fundamental principles of corporate governance that is openness, integrity and accountability as means to influence compliance.¹⁸⁹ Accountability is regarded as a tool measure corporate performance. With it, the confidence of stakeholders is increased. It is achieved through faithfulness in various aspects of corporate governance especially reporting. The more accountable corporate governors are, the more likely it is that results of performance measurement processes are going to be a true and fair representative of the performance being measured.¹⁹⁰

4.3 The factors that influence level of compliance

Potential factors of the compliance levels of corporate governance include the diffusion of an international benchmark model of good governance, a country's legal system, the desire to attract foreign investors and the influence of interest groups.¹⁹¹ Most of the corporate governance best practice codes are of the "comply or explain" type, which means that firms need to mention the cause of non-compliance whereas

¹⁸⁷ Harris M Systems and processes in Corporate Governance to the applied corporate Governance, <http://www.Committeewise.com> (accessed on 03 August 2015)

¹⁸⁸ Fung B 'The Demand and Need for Transparency and Disclosure in Corporate Governance' (2014) *Universal Journal of Management* 72

¹⁸⁹ The Report of the Committee on Financial aspects of Corporate Governance, 1992

¹⁹⁰ Gray R., Owen D. and Adams C.A, *Accounting and Accountability: Changes and Challenges in Corporate Social and Environmental Reporting* (1996) chapter 1

¹⁹¹ Hossain, M., Prevost, A. K., & Rao, R. P 'Corporate Governance in New Zealand: The Effect of the 1993 Companies Act on the relation between Board Composition and Firm Performance'. (2001)9 *Pacific-Basin Finance Journal* 119

voluntary regulation allows corporations to ignore the non-compliance without explanation.¹⁹² Understanding the fundamentals of corporate governance compliance is important to see concrete evidence concerning companies that operate in the “apply or explain” environment. Another point for noting is that the “apply or explain” nature of corporate governance regulation gives more flexibility to companies in compliance. Regulatory compliance is another important factor that differentiating internal or external mechanisms of corporate governance used to monitor managerial accountability.¹⁹³

The elements of corporate governance compliance reveal that the existence of corporate governance regulation is indeed a significant factor in companies compliance levels. In fact, the results suggest that firms comply with regulation even in the absence of mandatory obligation to comply.¹⁹⁴ Long term business operation has a significant effect on corporate governance compliance, which implies that corporate governance practices increase with the maturity of the company. In addition, concentrated ownership also correlates with better corporate governance practices with regulation.¹⁹⁵

Research has also revealed that corporate governance regulations is positively associated with stock exchange listing tenure, business operating tenure and concentrated ownership structure of companies, and negatively associated with the business operating cycle.¹⁹⁶ In addition to regulation, governance practices are also reflected in different factors such as culture, traditional financial options, corporate ownership patterns and legal origins.¹⁹⁷ It is generally accepted that the purpose of regulations concerning corporate governance is not to increase the value of companies but to enhance the safety of investors. The existences of corporate governance regulations are considered as an important factor of compliance.

¹⁹² La-Porta, R., Lopez-de-silanes, F & Shleifer, A. ‘Corporate Ownership around the world’ (1999) 54(2) *Journal of Finance* 471.

¹⁹³ Klein, A. ‘Firm performance and board committee structure’ (2003)41 *Journal of Law and Economics* 275.

¹⁹⁴ Bhuiyan, M.B., Roudaki, J. and Clark, M. ‘The effect of corporate governance regulations on firm value: New Zealand evidence’ (2010) 22nd *Asian-Pacific Conference on International Accounting Issues*, Gold Coast, Australia, November 7-9

¹⁹⁵ Jensen, M. C., & Meckling, W. H. ‘Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure’ (1976)3(4) *Journal of Financial Economics* 305

¹⁹⁶ Zattoni A & Francesca C ‘Why adopt coded of good corporate governance? A Comparison of Institutional and efficiency perspectives’ (2008) 8.

¹⁹⁷ Zattoni A & Francesca C ‘Why Adopt Codes of Good Governance? A Comparison of Institutional and Efficiency Perspectives’ (2008) 8 *Corporate Governance Review* 3

Consequently pressure from the regulatory authorities has a potential of encouraging companies to comply with voluntary codes of best practice.

Another factor that increases the possibility of better corporate governance compliance with regulations is the concentration of ownership status within corporations. Similarly, firms operating for a long time and stock exchange listing status of long tenure indicate better compliance with regulations.¹⁹⁸ The benefit to corporate compliance will encourage accountability and lower earnings management that results in effective decision-making information being given to the stock market for investors. Investment decisions on the other side will become more effective in a regulated corporate governance environment and thus increase investor confidence resulting in higher firm value.

Regulations and governance act in a harmonising manner to resolve the problem associated with absentee owners. Regulations also reduce management dominance in most corporations by increasing the influence of external parties such as auditors and shareholders. The said has been validated by Denis when he said that regulation serves as the most basic external corporate governance mechanism and has received greater attention since the beginning of 21st century.¹⁹⁹ He further contends that the general regulations and civil laws require the firms to have a minimum level of corporate governance structure to operate in a competitive market. Kole and Lehn on the other hand affirm this in the sense that firms will not be able to exist without corporate governance.²⁰⁰

Himmelberg made other finding which talks to the level of protection as another factor that can influence the level of compliance on corporate governance. He says that the level of protection that is offered to investors has two components one being external one, related to the legal environment where the firm operates (legal protection), and the other an internal one, related to the type of activity carried out

¹⁹⁸ Owusu-Ansah, S. 'Factors Influencing Corporate Compliance with Financial Reporting Requirements in New Zealand' (2005) *International Journal of Commerce and Management*, 15(2), 141

¹⁹⁹ Denis D Twenty-five years of corporate governance research and counting (2001) 191

²⁰⁰ Kole, S., & Lehn, K. 'Deregulation, the Evolution of Corporate Governance Structure and Survival' (1997)87(2) *The American Economic Review* 421.

and to other observable firm characteristics (endogenous protection).²⁰¹ He continues to say that investor protection refers to a collectivity of those features of the legal, institutional, and regulatory environment and characteristics of firms or projects that facilitate financial contracting between inside owners (managers) and outside investors.²⁰² Under this point of view it is possible that firms within a country can offer different levels of protection to their investors, due to their operational specifications and the different degrees of interest they could have to voluntarily adopt better corporate governance practices.

Katherina Pistor and Chenggang Xu on the other hand raise a point of incomplete law as one of the factors that can cause a lack of investor protection. They define law as incomplete when law makers are unable to foresee all future contingencies.²⁰³ Securities law and investor protection present a fine example of the incomplete law problem.²⁰⁴ It is not possible for company and securities law to unambiguously define every actionable lack of due care on the part of directors and managers, every method a manager or controlling shareholder might use to misappropriate or misuse company assets.²⁰⁵ Potential harm comes to investors in an infinite variety of forms.²⁰⁶ They conclude their argument by saying that 'other means of law-making and law enforcement are required to achieve optimal law enforcement.'²⁰⁷ They suggest that proactive law enforcement combined with the right to adapt rules flexibly over time can serve as a solution.²⁰⁸

Enforcement of the regulations, laws on the books or voluntary codes is key to effective corporate governance especially at the transitioning and developing countries.²⁰⁹ Corporate governance and enforcement mechanisms are intimately linked as they affect firms' ability to commit towards their stakeholders, in particular

²⁰¹ Himmelberg et al. Understanding the determinants of managerial ownership and the link between ownership and performance (1999, 2001) 53 (3) *Journal of Financial Economics* 353

²⁰² Himmelberg et al. Understanding the determinants of managerial ownership and the link between ownership and performance (1999, 2001) 53 (3) *Journal of Financial Economics* 354

²⁰³ Pistor, K and Chenggang Xu, *Incomplete Law – A Conceptual and Analytical Framework – And its Application to the Evolution of Financial Market Regulation* (2003) 20

²⁰⁴ Pistor, K and Chenggang Xu *Incomplete Law – A Conceptual and Analytical Framework – And its Application to the Evolution of Financial Market Regulation*(2003) 30

²⁰⁵ Gennaioli N and Shleifer A The Evolution of Common Law. (2007)115(1) *Journal of Political Economy* 43.

²⁰⁶ Millstein I M, Shri G. N, Berglöf B E & Claessens S *Enforcement and corporate governance: Three views* (2005) 2

²⁰⁷ Pistor, K and Chenggang Xu, *Incomplete Law – A Conceptual and Analytical Framework – And its Application to the Evolution of Financial Market Regulation* (2003) 7

²⁰⁸ Pistor, K and Chenggang Xu, (2003) 23

²⁰⁹ Glaeser, E L and Andrei S 'The Rise of the Regulatory State'(2003) 41(2) *Journal of Economic Literature* 401.

towards external investors.²¹⁰ When the general enforcement environment is weak and specific enforcement mechanisms function poorly, as in many developing and transition countries, few of the traditional corporate governance mechanisms are effective.²¹¹ A range of private and public enforcement “tools” can help reduce these costs and reinforce other supplementary corporate governance mechanisms. The limited empirical evidence suggests that private tools are more effective than public forms of enforcement in the typical environment of most developing and transition countries.²¹²

The separation of ownership from management raises the issue of monitoring managerial activities to ensure investor confidence. Users of accounting information, such as investors, government agencies, auditors and financial analysts, have focussed on monitoring corporate governance systems.²¹³ This leads to increased disclosures about corporate governance, demands for the regulation of systems of corporate governance, and consequentially, enhanced internal control systems.²¹⁴ Regulators, academics and practitioners around the world now evaluate corporate governance regulations and compliance from inception to the implementation of a suitable and sustainable system that takes account of the socio-economic environment relevant to any particular company.²¹⁵

Another factor that influence the corporate’s compliance with corporate governance is the role of the independence of directors that includes amongst other things, providing valuable advisory role to the corporations they direct. There is a direct relation between director’s independence and thrift survival of a corporation. The said corroborates evidence from other studies that shareholders fare better during significant corporate events, such as acquisitions, poison pill adoption and corporate restructuring, when their firm’s board is dominated by independent outside directors.²¹⁶

²¹⁰ Glaeser, E L., and Andrei S ‘The Rise of the Regulatory State’ (2003)41(2) *Journal of Economic Literature* 401.

²¹¹ La Porta R, Lopez-de-Silanes F, and Shleifer A ‘The Economic Consequences of Legal Origins’ (2008) 46(2) *Journal of Economic Literature* 285

²¹² Millstein I M, Shri G. N, Berglöf B E & Claessens S *Enforcement and corporate governance: Three views* (2005) 2

²¹³ Dalton C M & Dalton D R *Corporate governance best practices: the proof is in the process* (2006). 5

²¹⁴ Dalton C M & Dalton D R (2006). 5

²¹⁵ Dalton C M & Dalton D R (2006). 5

²¹⁶ Shivasani A & Zenner M *Best Practices in Corporate Governance: What Two Decades of Research Reveals* (2004)12

4.4 International Perspective

Since the 17th century, governments have had to regulate limited liability. They had to ring fence corporate property from the creditors of individual shareholders and vice versa. The institutionalisation of today's market economies is a clear difference between our time and the earlier regime. This could not have happened without public policy intervention; and it will not continue to bear its fruits if policy makers do not continuously upgrade the basic rules of company governance, to reflect rapidly changing environments.²¹⁷

The essence of corporate governance is concerned with issues of ownership and control of the enterprise.²¹⁸ Ownership referred to in this context is the legal allocation of property rights among the principal stakeholders or corporate constituencies that is shareholders, creditors and employees. Control on the other side refers to the way in which legal rules and social norms interact to determine the balance of power among these groups.²¹⁹ A legal perspective is important in this case because of the pivotal role which legal rules play in constituting the corporate form and in framing the options available to the various parties with an interest in or affected by the enterprise.

The financial crisis 'has been a wake-up call' to the failings of the current Anglo-American system of corporate governance.²²⁰ This has served as an opportunity to critically evaluate the current system and the values it represents. A number of issues in the governance of financial institutions have been blamed for the global financial crisis, including a lack of transparency and reliability, reckless board practices and remuneration policies that encourage 'short-termism' and high levels of risk taking.²²¹ Arora submits that, due to the pivotal role of financial institutions within society, the directors of such institutions must no longer be allowed to possess such a narrow focus; centred solely on short term financial success. Instead, the stability

²¹⁷ Nestori S *International Efforts to Improve Corporate Governance: Why and How* (2001) 8

²¹⁸ Berle A and Means G. C. *The Modern Corporation and Private Property*. New York: Commerce Clearing House.(1932)45

²¹⁹ Shleifer, A., and Vishny, R. W. Large Shareholders and Corporate Control. (1986)*The Journal of Political Economy*, 94(3)461

²²⁰ The Rt Hon Lady Justice Arden, 'Regulating the Conduct of Directors' (2010) 10(1) *JCLS* 1

²²¹ Arora A 'The Corporate Governance Failings in Financial Institutions and Directors' Legal Liability' (2011) 32(1) *Comp. Law* 3

of financial institutions must be guaranteed to protect against the economic and social fallout of recession.²²²

Anglo-American systems were viewed as unfavourable to insider systems because corporate control was exercised by agents with permanent economic ties with the company.²²³ However, the separation between ownership and control in public companies led scholars to identify the potential agency problems that arise when a dispersed group of shareholders are unable to monitor and control the behaviours of management.²²⁴ It was in the 1980, an era of globalisation, when analysts came to an agreement that agency problems can lead to poor corporate governance.²²⁵ They were of the view that management was effectively shielding itself from accountability.²²⁶ The American model of corporate governance provides a powerful legal right to shareholders to call corporate managers to account.²²⁷

Since the late 1970 the Chinese's 'economic reform policies on the other hand have been balanced by the dual objectives of enhancing economic efficiency and strengthening the position of the ruling Communist Party. SOE reforms, which began thirty years ago, are case in point'.²²⁸ SOEs generally operated less efficiently than private firms due to a number of various reasons being that the government provided 'softer budget constraints' than markets, the policy burden from achieving various costly social goals, agency issues; and/or a lack of competition.²²⁹ In undertaking SOE reforms, policy makers face at least three options: changing ownership mainly through privatisation, introducing competition, or managerial and institutional reforms.²³⁰ Privatisation involves selling off inefficient, unprofitable, or loss-making SOEs to non-state owners. While these reforms were designed to tackle the obvious inefficiencies inherent in state enterprises, they needed to be done slowly in order to preserve China's political and social stability.²³¹ Greater exposure to competition requires market-oriented reforms that expand the reach of the market economy,

²²² Arora A (2011) 32(1)

²²³ Shleifer, A., and Vishny, R. W. 'Large Shareholders and Corporate Control' (1986) 94(3)*The Journal of Political Economy* 461

²²⁴ Martin, K.J. and McConnell, J. J. 'Corporate performance, corporate takeovers and management turnover'. (1991) *Journal of Finance*, 46(2):671

²²⁵ Porter M 'Capital disadvantage: America's failing capital investment system' (1992)*Harvard Business Review* 65

²²⁶ Martin, K.J. and McConnell, J. J. 'Corporate performance, corporate takeovers and management turnover' (1991) 46(2) *Journal of Finance*, 671

²²⁷ Jensen, M. 'The modern industrial revolution, exit and the failure of internal control systems'. (1993) Vol.48 *Journal of Finance*, 831.

²²⁸ Franklin A, Qian J, and Qian M. *Law, Finance, and Economic Growth in China* (2002) 5

²²⁹ Kornai J *The Road to a Free Economy: Shifting from a Socialist System* (1980) 23

²³⁰ Shirk, S *The Political Logic of Economic Reform in China* (1993) 12

²³¹ Chong-En B, Liu Q, Lu J, Song F M, and Zhang J *Corporate Governance and Firm Valuations in China*. (2002) 16

through breaking up state monopolies, removing barriers to entry for non-state players and exposing SOEs to market-determined input prices.²³² Their presence in national economies was justified on various grounds, including: the necessity to provide public goods; regulating or benefiting from natural monopolies; acting as 'national champions'; and being the fundamental production unit in the case of centrally planned economies as in China from the 1950s until the economic reforms of the 1980.

The overhaul of the SOE sector in China occurred from the mid-1990s with a large scale sell-off of loss-making SOEs, only partial privatisation was pursued, as the government kept the majority stakes in large SOEs. Corporatisation and corporate governance reforms include the setting up of internal governance structures, those are decision making procedures and standards so that management will have incentives to pursue profit and are accountable for their business decisions. In the meantime, the Government pushed remaining SOEs towards corporate governance reforms and greater exposure to competition.²³³ China's mixed approach to SOE reform also reflects that markets and the broader non-state sector were almost non-existent when China began its reform process. This is in contrast to Australia and other western market economies prior to the programme of de-regulation and privatisation of the 1980s, where vibrant markets and market-oriented private firms already co-existed with state-owned companies. Instead, the authorities recognised that China needed time to develop markets, market-friendly institutions, and market-compatible norms, ideas, practice, and enforcement.²³⁴

The main key SOE reform objective has been to establish a 'modern enterprise system'. The modern enterprise system, as sanctioned in 1993, consists of four pillars: clarification of property rights; clarification of rights and responsibilities; separation between government administration and corporate business; and 'scientific' management.²³⁵ Over time, a growing number of SOEs have adopted modern corporate structures with boards of directors responsible to shareholders and for supervising the management of business operations. This has led to the

²³² Zhiwu C 'Capital Markets and Legal Development: The China Case'. (2003) 14 *China Economic Review*:451

²³³ Lin, Justin Yifu, Cai Fang, Li Zhou *The China Miracle: Development Strategy and Economic Reform* (2003) 5

²³⁴ Lu Litao 'New thinking on the relations between governments and markets' <http://www.yicai.com/news> (accessed on 15 July 2015)

²³⁵ Naughton B 'Programs of Economic Reform Begin to Emerge in China Leadership Monitor' <http://www.hoover.org/publications/china-leadership-monitor> (accessed 15 July 2015)

administrative functions being stripped off from SOEs' business operations.²³⁶ SOEs' corporate governance has also been strengthened through shareholding reforms, with a growing number of SOEs being publicly listed. SOEs' ownership structure has become more diversified, involving the participation of non-state private and foreign firms as majority or minority shareholders.²³⁷ These reforms have moved SOEs away from being direct affiliates to the central planning system, with the government no longer involved in most SOEs' day-to-day operations.²³⁸

The New Zealand public reform process of the late 1980 and early 1990 was notable for its attempt to clarify public accountability through the specification of outputs, contractual agreements and the disaggregation of government departments into smaller, more sharply focused agencies.²³⁹ While the reforms achieved managerial improvements, the accountability regime was less successful because of the difficulties of specification and the continuing robustness of Ministerial responsibility in the face of attempts to limit the political control and accountability.²⁴⁰

The New Zealand Stock Exchange and Securities Commission on the other hand issued the Corporate Governance Best Practice Code of 2003 and Corporate Governance: Principles and Guidelines of 2004 in addition to other common laws such as the Companies Act 1993.²⁴¹ Ever since, most of New Zealand companies comply with corporate governance regulations even though it is not mandatory to do so.²⁴² Evidence was also found of compliance with corporate governance regulations being positively associated with stock exchange listing tenure, business operating tenure and concentrated ownership structure of companies, and negatively associated with the business operating cycle.²⁴³

²³⁶ Derek S 'The Fall and Rise of Chinese State-Owned Enterprises' <http://www.heritage.org> (Accessed on 15 July 2015)

²³⁷ Derek S 'The Fall and Rise of Chinese State-Owned Enterprises' <http://www.heritage.org> (Accessed on 15 July 2015)

²³⁸ Lu Litao 'New thinking on the relations between governments and markets' <http://www.yicai.com/news> (accessed on 15 July 2015)

²³⁹ Reddy K, Locke S & Scrimgeour Corporate governance practices of small cap companies and their financial performance (2008) vol 4 *International Journal of Business Governance and Ethics* 51

²⁴⁰ Reddy K, Locke S & Scrimgeour Corporate governance practices of small cap companies and their financial performance (2008) vol 4 *International Journal of Business Governance and Ethics* 51

²⁴¹ Chiu P & Monin J Effective corporate governance from the perspective of New Zealand fund managers(2003)11(2) *Corporate governance: An international Review* 123

²⁴² Chiu P & Monin J(2003)123

²⁴³ Coles J, McWilliams V & Sen N An examination of the relationship of governance mechanisms to performance. (2001) 26(2)*Journal of Management* 195

4.5 South African Perspective

Following King II, the Johannesburg Stock Exchange Limited (JSE) introduced the requirement that listed companies are required to include in their annual report a narrative statement as to how they had complied with the principles set out in King II. That will enable various stakeholders to evaluate the extent of the company's compliance. In cases of non-compliance listed companies are required to state reasons for non-compliance to be justified. There are examples of companies listed on the JSE that have not followed practices as recommended but have explained the practice adopted and flourished. In these examples, the boards have ensured that acting in the best interests of the company was the overriding factor subject to proper consideration of the legitimate interests and expectations of all the company's stakeholders.

Foreign institutional investors have regarded the South African listed companies as being among the best governed in the world's emerging economies.²⁴⁴ This is as a result of the JSE listing requirements that follow a good governance practices and principles. This was evidence by major capital inflows into South Africa before the global financial crisis of 2008.

King III principles are based on an apply or explain approach. This means that directors are legally obliged to act in the best interests of the company. In an apply or explain approach, the board of directors could decide that the recommendation would not be in the best interests of the company based on valid reasons. The said approach is based on the objective of good corporate governance principles of fairness, accountability, responsibility and transparency. Explaining how the principles and recommendations were applied, or if not applied, the reasons therefore, results in compliance. The duty to provide such information does not necessarily rely on the ultimate compliance officer or a bureaucrat ensuring compliance with statutory provisions, but the stakeholders.

4.6 Conclusion

The enforcement of the company law, the regulatory framework, the Listing Rules, the King Codes on Corporate Governance, ethical standards, corporate strategy and

²⁴⁴ Prof Romano of Yale School of Law

government policy is an effective measure on the impact of corporate governance standards. Corporate governance compliance as one of major factor provides additional tool to both the board of directors and the shareholders because it serves as an effective monitoring mechanism to reduce the agency conflict. It imposes more stringent monitoring and increases the involvement of the Board of Directors in the corporate's decision making. In cases whereby the corporate governance is not binding, corporates' decision to adopt the corporate governance codes must be supported by prudent justification.

There is much to be learnt from New Zealand and China in an attempt to clean up South African failing SOEs. The China's new far-reaching SOE reforms in improving efficiency, ripping out corruption and boosting its competitiveness through transparent reporting, independent boards and adhering to new post-global financial crisis investment behaviour regulations for companies has helped in a great deal.

New Zealand ownership reforms of state-owned enterprises (SOEs) that clarified the state's role as owner, reduce fragmentation of ownership responsibilities across multiple institutions, and enhance accountability for results can be a lesson for South Africa as well. Their reforms were aimed at giving SOE boards and management greater autonomy in operational decision making. This is what South Africa needs today. The goal should be to separate the state's ownership functions from its policy-making and regulatory functions to sharpen the focus on ownership issues and minimise the conflicts of interest. These reforms involve moving away from traditional ownership models in which line ministries have ownership responsibilities to centralised ownership arrangements

In an apply or explain approach, the principles override specific recommended practices. Nevertheless, some principles and recommended practices have been incorporated into the companies Act and as such it is mandatory to comply with the law. This does not leave room for interpretation. The good news is that South Africa has progressed in that area starting from the recommendations made in King II, which were subsequently adopted in King III and are now enacted into law. Apart

from the Companies Act, other legislation have made provisions for the duties of the directors. The Public Finance Management Act (PFMA) is one example that has provision for the regulation of the management of the State-Owned Companies and defines them as national government business enterprises and national public entities.

Further international examination will be discussed in the next chapter to locate a South African approach in the context of the Anglo-American model.



CHAPTER FIVE

COMPARATIVE INTERNATIONAL EXAMINATION

THE DIVERGENCE BETWEEN U.S. AND U.K. APPROACHES

5.1 Introduction

A review of the selected governance codes and principles reveals that apart from the content the codes can be differentiated in terms of their compliance requirements. In that regards two types of requirements are identified in this Chapter that is voluntary adoption, which entails comply or explain in a case of non-adoption, should be provided with reasons for that non-adoption as it is being practiced in United Kingdom. The other requirement is mandatory adoption which entails that the comply or else approach that is being practiced in the United State of America.

The comparison between the voluntary adoption and mandatory adoption matters will be analysed to determine the effectiveness of the reform. In the recent years the relative merits of both approaches in their respective order have been subjected to intense debate. The comply or explain approach depends on self-regulation as recommended by Cadbury Committee Codes. Two key logical conclusions emerge. First is that companies should not view compliance with corporate governance codes as a substitute to careful thinking as to what is the most appropriate control framework for their specific circumstance.²⁴⁵ The second conclusion is that non-compliance with a particular provision could very well be acceptable if it is accompanied by a meaningful explanation as to why it is appropriate in the circumstances. A meaningful explanation should set the context, give a convincing rationale and describe mitigating action to address any additional risk.²⁴⁶

5.2 Voluntary codes

In the U.K. Corporate governance practices received increasing attention since the 1990s, with influential reports issued by the Cadbury Committee (1992), Greenbury Committee (1995), Hampel Committee (1998), and Turnbull Committee (2003) and

²⁴⁵ Financial Report Council (FRC) What constitutes an explanation under 'comply or explain'? (2012)<http://www.haygroup.com> (Accessed 10 August 2015)

²⁴⁶ Financial Report Council (FRC) What constitutes an explanation under 'comply or explain'? (2012)<http://www.haygroup.com> (Accessed 10 August 2015)

Sir Derek Higgs (2003).²⁴⁷ These reports resulted in various corporate governance codes and recommendations, the most recent being the Combined Code of Corporate Governance, that was introduced in the UK in 1998, is widely regarded as an international benchmark for good corporate governance practice.²⁴⁸

The flexibility it offers to companies, who can choose between complying with its principles or explaining stands in sharp contrast to mandatory systems of the Sarbanes-Oxley Act in the US. The merits of such flexibility are thought to lie in its ability to encourage companies to adopt the spirit of the Code, rather than the letter of the law, whereas a more statutory regime would lead to a "box-ticking" approach that would fail to allow for sound deviations from the rule and would not foster investors' trust.²⁴⁹ The Code fostered compliance, especially in areas not covered by its forerunner, the Cadbury Code. For example, such provisions include the appointment of a senior independent non-executive director or 12 months service contracts for executive directors

The level of compliance with the Code in this instance from the sample of 10; 288 companies selected indicated that there were 8; 712 cases of compliance resulting in an overall frequency of compliance of 84.7%.²⁵⁰ There are 44% of companies which did not comply in 2004 on at least one of the principles compared to more than 90% in 1998. In 2004, there were 14% not complying on more than 2 principles and 5% not complying on more than 3.²⁵¹ On average, overall compliance per principle increases from 76.7% in 1998 to 91.4% in 2004. Compliance increased for all principles, except for that relating to the composition of the audit committee, where it remained approximately the same. Two out of eight principles have the maximum increase in compliance over that period: service contracts (from 35% to 80%) and senior non- executive director (from 57% to 92%). Interestingly, these are the two principles which were either not present in the Cadbury code (SNED) or present at different levels (3 year length of service contract instead of 1 year).²⁵²

²⁴⁷ Arcot S, Bruno V & Grimaud A F *Corporate Governance in the UK: is the Comply-or-Explain Approach Working?* (2005) 4

²⁴⁸ Arcot S, Bruno V & Grimaud A F *Corporate Governance in the UK: is the Comply-or-Explain Approach Working?* (2005) 1

²⁴⁹ Arcot S, Bruno V & Grimaud A F (2005) 6

²⁵⁰ Owusu-Ansah, S Factors Influencing Corporate Compliance with Financial Reporting Requirements in New Zealand (2005)15(2) *International Journal of Commerce and Management* 141

²⁵¹ Owusu-Ansah, S (2005)15(2) 142

²⁵² Conyon, M. and C.Mallin A review of compliance with Cadbury, (1997) vol 22 *Journal of General Management* 24

The great achievement of the Code is in the very high number of compliances. As compared to a statutory regime a flexible system such as the Combined Code adds value if there are conditions under which one size does not fit all. If there is full compliance, or if no meaningful explanations are observed in case of non-compliance, the “explain” part of the code is ineffective.²⁵³ The relative benefit of flexibility, relative to a statutory regime, must be therefore commensurate to the number of good explanations.

Security Exchange Commissions or the regulators of the public limited liability companies (PLCs) in many countries have introduced non-regulatory codes or voluntary codes on corporate governance. Code of Best Practices, popularly known as the Cadbury guidelines and the subsequent introduction of Combined Code on Corporate Governance provide guidelines for the PLCs to improve corporate governance practice in the UK.²⁵⁴ PLCs in the Main Market of the London Stock Exchange are required to either comply with or explain the reasons for not complying with the Combined Code. The comply or explain principle suggests listed companies to choose the best practices to suit the size of the firm, future needs and potential agency conflicts rather than pushing firms on to a mandatory compliance or to a model of ‘one-size fit-all’.

Colton submits that the comply or explain concept has been hailed as a pragmatic tool that can improve corporate governance without the need for inflexible burdensome and misguided rules, laws or regulation.²⁵⁵ Cadbury codes were conceived as a supplement to UK company law and listing requirements in the institutional investor-dominated setting of the London market in the early 1990.²⁵⁶ The Code deliberately focused on the working of one-tier boards and on the role of auditors in the United Kingdom.²⁵⁷

Sir John Parker advocates commercial freedom and sound governance rather than mandatory compliance of the codes. His believe is based on the fact that the

²⁵³ Arcot S, Bruno V & Grimaud A F (2005) 6

²⁵⁴ Cadbury A. *The financial aspects of corporate governance, report of the committee on the financial aspects of corporate governance*.1992

²⁵⁵ Colton C C ‘20th Anniversary of the UK Corporate Governance Code Financial Reporting Council’ (2012) 11 <http://www.frc.org.uk> (accessed 06 October 2015)

²⁵⁶ Colton CC (2012) 11

²⁵⁷ Colton CC (2012) 11

prescribed rigid rules that requires strict adherence could actually be counter-productive and harm good governance.²⁵⁸ He continues to say that business environment changes so rapidly and the rules are often out of date before the ink dry up.²⁵⁹ Regulating behaviour in this way can, perversely, encourage companies to merely comply with the letter of the rules rather than making ethical judgements that aim to meet their spirit.²⁶⁰

Voluntary regulations, however, can be effective because compliance enables companies to satisfy specific requirements, and the level of compliance is influenced, if not determined, by the characteristics of these firms.²⁶¹ Consequently, it is important to determine the factors that influence compliance with corporate governance regulations in a regulated environment. Irrespective of the nature of corporate governance regulations, it is apparent that regulation has a positive impact on governance compliance.²⁶²

5.3 Mandatory corporate governance regulation

For the USA the journey begun in the 1960s and 1970s where these decades were characterized by strong managers and weak owners. Corporate law was a matter of state rather than federal regulation.²⁶³ Only securities law is regulated at the federal level, and the emphasis of the Security and Exchange Commission (SEC) is usually on disclosure rather than substantive provisions regarding company structure.²⁶⁴ Many investor rights were essentially vested with the board, yet companies have great latitude in shaping the structure and powers of boards in practice.

The federal nature of corporate law laid the foundations for managerialism within U.S. corporate governance, since shareholders rights remained relatively weak under this competitive structure despite the existence of stronger national regulation over securities trading.²⁶⁵ In 1974, the SEC began requiring disclosure of the

²⁵⁸ Parker J '20th Anniversary of the UK Corporate Governance Code Financial Reporting Council' (2012)42 <http://www.frc.org.uk> (accessed 06 October 2015)

²⁵⁹ Parker J (2012)42 <http://www.frc.org.uk> (accessed 06 October 2015)

²⁶⁰ Parker J (2012)42 <http://www.frc.org.uk> (accessed 06 October 2015)

²⁶¹ Collett P & Hrasaky S *Corporate Governance: An International Review* volume 1(2005) 189

²⁶² Shivasani A & Zenner M *Best Practices in Corporate Governance: What Two Decades of Research Reveals* Volume 16 (2004) 29,

²⁶³ Hollister H. T: Shock Therapy⁴ for Aktiengesellschaften: Can the Sarbanes-Oxley Certification Requirements Transform German Corporate Culture, 'Practice and Prospects?' (2005) 25 *Northwestern Journal of International Law & Business*. 453.

²⁶⁴ Hollister H. T:(2005) 453.

²⁶⁵ Cioffi W J *Public Law and Private Power: Corporate Governance Reform in the Age of Finance Capitalism* (2010) 5

existence of an audit committee and published guidelines about the activities of audit committees in 1978. Only in 1977 did the New York Stock Exchange require an audit committee with directors independent of management as part of its listing requirements. Directors from affiliated firms could serve among these directors unless such relationships would interfere with the exercise of independent judgement.²⁶⁶

The 1980s saw a huge wave of hostile takeovers that threatened the hegemony of U.S. managers.²⁶⁷ Institutional investors and particularly public-sector pension funds such as CALPERs became much more active players in corporate governance, using their growing blocks to exercise greater voice in corporate management.²⁶⁸ Power began to shift substantially toward investors due to the rise of new types of institutional investors and the advent of hostile takeovers. Institutional investors emerged as an important new category of shareholder.²⁶⁹ By the 1990s, the trend toward greater shareholder influence continued, but was reshaped by the responses of managers. Managers aligned themselves increasingly with the interests of shareholders through new forms of executive pay and adopting the ideology of shareholder value.²⁷⁰

Scandals surrounding Enron and Worldcom focused substantial criticism on the U.S. corporate governance. Enron was a Texas company that initially specialised in the creation of energy markets which allowed utility companies to avoid the use of vertical integration strategies and which later expanded into other energy and telecommunications markets.²⁷¹ Despite the appearance of stable revenues and increasing profitability, Enron's accounting and auditing practices were such that speculative predictions were recorded as future sales, and loans were camouflaged as commodities contracts that had already been paid. By the end of 2001 Enron's financial situation had become parlous and the energy giant was forced to apply for

²⁶⁶ Gordon J. N. 'The rise of independent directors in the United States, 1950-2005: Of shareholder value and stock market prices' (2007)59 *Stanford Law Review* 1480

²⁶⁷ Useem M. *Investor capitalism: how money managers are changing the face of corporate America* (1st ed.) (1996) 20.

²⁶⁸ Useem M. (1996) 21

²⁶⁹ Useem M (1996) 22.

²⁷⁰ Dobbin F. and Zorn D: 'Corporate Malfeasance and the Myth of Shareholder Value' (2005) 17 *Political Power and Social Theory* 179.

²⁷¹ Ribstein L E: *Sizing Up Sox* (2005)3.

Chapter 11 Bankruptcy Code protection on 2 December 2001 which cost investors, employees and creditors billions of dollars.²⁷²

Ribstein attributes the collapse of Enron and other major companies to agency costs and gatekeeper failure. At Enron, the gatekeepers found themselves with conflicts of interest which caused them to overlook wrongdoing. First, the common behaviour of executives at Enron and other companies was overly-competitive, optimistic to the point of delusion, and fundamentally unethical.²⁷³ Second, a number of new forms of accounting and transaction structures, including derivatives, structured financing and special purpose entities, made fraud difficult to identify for investors, regulators, auditors and boards of directors.²⁷⁴ Third, investors had been lulled into a false sense of security by the new opportunities offered by internet start-ups and innovative business structures, and showed less scepticism and prudence when investing in companies such as Enron.²⁷⁵

These events mounted a strong challenge to the prevailing wisdom about market-based systems of corporate governance. There was a political reaction that led to the development of Sarbanes Oxley (SOX) legislation and subsequent changes in SEC listing requirements that altered the way U.S. corporate governance practices operate. As such the United States of America chose to codify a significant part of its governance in an act of Congress known as the Sarbanes-Oxley Act of 2002 (SOX). The Act as drafted by U.S. Congressmen Paul Sarbanes and Michael Oxley was aimed at improving corporate governance and accountability. It further established strict standards for all publicly traded companies in the United States. It does not apply to private companies. It is administered by the Securities and Exchange Commission (SEC), which deals with compliance, rules, and requirements.

The SOX does not only affect the financial side of corporations, but also Information Technology departments charged with storing a corporation's electronic records.²⁷⁶ The Act is not a set of business practices and does not specify how a business should store records, rather, it defines which records should be stored and for how

²⁷² Edwards J, Gajic M and Lynch C, 'Public Company Accounting and Investor Protection in the United States: Implications for Australian Corporate Governance from the Sarbanes-Oxley Act', (2002) 20 *Company & Securities Law Journal* 413.

²⁷³ Ribstein L E: *Sizing Up Sox* Legal Research Foundation Conference, Auckland (2005)3

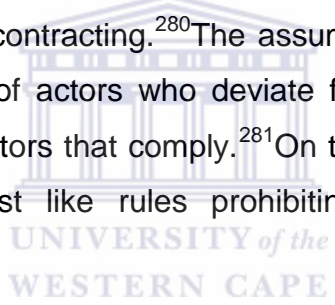
²⁷⁴ Ribstein L E (2005) 4

²⁷⁵ Ribstein L E (2005) 4.

²⁷⁶ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat 745, s802

long. SOX states that all business records, including electronic records and electronic messages, must be saved for not less than five years. The consequences for non-compliance are fines, imprisonment or both.²⁷⁷

This statutory regime is known as 'comply or else'. In other words, there are legal sanctions for non-compliance. There was a concern raised that with this new regime the board and management may focus on compliance at the expense of enterprise. To address the concern it was resolved that the duty of the board is to undertake a degree of risk for reward and to try to improve the economic value of a company.²⁷⁸ If the board has a focus on compliance, the attention on its ultimate responsibility and performance may be diluted. New U.S. regulation gives greater power and institutional scope to the state agencies such as the SEC to regulate important 'gatekeepers' and professional intermediaries who are central to market-based mechanisms of monitoring.²⁷⁹ Mandatory law matters because it leads to strong markets and enables private contracting.²⁸⁰ The assumption is that once the regime is implemented, the number of actors who deviate from the regime will be much smaller than the number of actors that comply.²⁸¹ On this view, mandatory corporate governance is necessary just like rules prohibiting insider trading to protect investors.²⁸²



5.4 Governance and value

The era after SOX also greatly increased awareness of the differences between the U.S. and British approaches to corporate governance. While both are considered to be broadly similar shareholder-oriented models, the U.S. regulatory regime is based much more on hard law and a regulatory state, unlike the British approach that relies more on soft law and self-regulatory mechanisms, such as Codes. The "one size fits all" approach of U.S. law sparked debate over the benefits of mandatory rules relative to more flexible sets of principles based on enabling set of rules.²⁸³ While a

²⁷⁷ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat 745, s803

²⁷⁸ Baker, R. L., Bealing Jr W. E., Nelson, D. A. &Staley, A. B. 'An institutional perspective of the Sarbanes-Oxley Act' (2006) 21(1) *Managerial Auditing Journal* 25

²⁷⁹ Baker, R. L., Bealing Jr W. E., Nelson, D. A. &Staley, A. B (2006) 26.

²⁸⁰ La Porta R, de-Silanes F L, & Shleifer A *What Works in Securities Laws?* (2004)13.

²⁸¹ Sinclair D 'Self-Regulation Versus Command and Control? Beyond False Dichotomies' (1997) 19 *law and policy* 529

²⁸² Ananda A I 'An Analysis Of Enabling Vs. Mandatory Corporate Governance: Structures Post-Sarbanes-Oxley' (2006) 31(1) *Delaware Journal Of Corporate Law* . 230

²⁸³ Ananda A. I: (2006) 230

wholly mandatory structure may yield slightly better compliance, its other benefits are uncertain and its costs are likely much higher.

Corporate governance is about value and is expected to enhance the interests and fulfil the aspirations of all stakeholders. The ultimate purpose of all corporation governance approaches is to create wealth for shareholders, as it is important to recognise that shareholders are indeed the residual stakeholders. As already indicated in the previous chapter compliance involve the board of directors to exercise their fiduciary responsibility in accordance with the rules and regulations that regulates their functions. These fiduciary responsibility or duties are legal concepts that form the basis of a board's legal relationship with the company's owners. Conversely the shareholders' relationship with the CEO, by contrast, entails both a binding contract and the trust of that CEO in controlling the shareholders' property. The duty of care, the duty of loyalty and the duty of disclosure forms part of distinct CEO's fiduciary duties and legal responsibilities to his company's shareholders. The duty of care refers to the CEO's responsibility to consider all of the available information relevant to business decisions, including the advice of experts and employees. The duty of care also includes the responsibility to understand and evaluate the company's day to day operations and the terms of agreements.²⁸⁴ The duty of loyalty requires that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation.²⁸⁵ This includes the responsibility to avoid conflicts of interest. Finally, the fiduciary duty of disclosure mandates that a CEO fully inform both the board of directors and the shareholders about the major issues facing the business

The obligations towards the contractual stakeholders such as customers, employees, vendors, creditors and the society get precedence over the interests of the shareholders. The contribution of other stakeholders to the success of the corporation is not less important than that of the shareholders. Unless the company blends a harmonious relationship among all the stakeholders, it may jeopardise its ability to create wealth on a sustained basis. The society benefits from receipt of

²⁸⁴ Bradley M & Schipani C A 'The Relevance of the Duty of Care Standard in Corporate Governance' (1989)75 *Iowa L. Rev.* 60.

²⁸⁵ *Gearhart Indus. v. Smith Int'l*, (5th Cir. 1984).741 F.2d 707, 719

taxes, generation of employment, and social commitment displayed as well as public projects undertaken by the company. Lenders benefit from safety of interest and principal, and they also gain from enhancement of their portfolio quality through improvement in the quality of their lending/investment portfolios. Employees benefit from salaries and benefits, and through stability of employment. The residual belongs to shareholders majority and minority and are shared appropriately. The board and management are expected to create value for all the stakeholders. Hence, governance processes must be such that wealth created is distributed across all classes of stakeholders in proportion to their contribution, and in keeping with market and business practices. It is in this perspective that the quality of management should be enhanced so that it is able to adapt to match the dynamics of the business environment. Eventually, all these decisions of companies impact the stability of their future wealth creation.

In South Africa, the King reports provided guidelines for both private companies and SOEs. Some of the principles were partially codified and that has placed South Africa in the top rank of emerging market economies that follow corporate governance codes. Even then the question can be raised as to whether there is sufficient institutional capacity to implement the codes. The said will be addressed in the following chapter.

5.5 Global initiatives on corporate governance

(a) World Bank Group and the Organization for Economic Co-operation and Development

The World Bank Group and the Organization for Economic Co-operation and Development drafted the Guidelines on Corporate Governance of State-Owned Enterprises which were adopted since 2005 as an internationally-agreed standard on how governments should exercise ownership of SOEs. The SOE Guidelines are being reviewed and revised in 2014 to take into account developments since their adoption and the experiences of the

growing number of countries that have taken steps to implement their recommendation.²⁸⁶

(b) Global Corporate Governance Forum (GCGF)

The Global Corporate Governance Forum (GCGF) co-founded by the World Bank Group and the Organisation for Economic Cooperation and Development is an advocate, a supporter, and a disseminator of high standards and practices of corporate governance in developing countries and transition economies. Through its activities, the Forum actively supports regional and local initiatives that address corporate governance by leveraging institutional support for reforms and initiatives that build local capacity and by making available technical and advisory assistance drawn from its wide network of international and private sector expertise. The Forum's donors include the International Finance Corporation, and the governments of Canada, France, Luxembourg, Norway, Sweden and Switzerland.²⁸⁷

(c) African Capital Markets Forum

The African Capital Markets Forum undertook a study on the state of Corporate Governance in Africa. Regional conferences were held in Kampala, Uganda, in June 1998 and September 1999 to create awareness and promote regional co-operation in matters of corporate governance. At the June 1998 Conference it was resolved that each member state be encouraged to develop both a framework and a code of best practice, to promote national corporate governance and that efforts be made to harmonise corporate governance in the East Africa region under the auspices of the East Africa Co-operation and through the establishment of a regional apex body to promote corporate governance.²⁸⁸

(d) Corporate Governance In Africa

²⁸⁶ OECD *Guidelines on Corporate Governance of State-Owned Companies*.2005 Paris: OECD.

²⁸⁷ OECD 'Promote global, regional, and local initiatives that aim to improve corporate governance' 2002 <http://www.eldis.org> (accessed 12 September 2015)

The African Development Bank has fully recognized over the last few years that good corporate governance is essential to Africa's future development. The Bank formulated a Bank Group Policy on Good Governance at the end of 1999 and related Operational Guidelines in 2001. These documents aimed to provide a flexible framework for mainstreaming governance into Bank operations and to pave the way for African countries to enhance their governance stance. One major outcome of the guidelines has been the formulation and implementation of the Country Governance Profile (CGP) as a Bank instrument. The CGP is designed to help the Bank to identify weaknesses in governance practices and to develop appropriate capacity-building programs. Identified shortcomings are addressed through specific projects/programs, including a new quick-disbursing instrument, viz. the Policy-Based Lending on Governance (PBLG).²⁸⁹

5.6 Corporate Governance in Commonwealth Authorities

The 56 countries in the Commonwealth, including South Africa and the 27 states in the EU including the United Kingdom, have opted for a code of principles and practices on a 'comply or explain' basis, in addition to certain governance issues that are legislated. The Commonwealth Association for Corporate Governance was subsequently established and developed the "Principles for Corporate Governance in the Commonwealth, CACG Guidelines". These were adopted at the November 1999 Commonwealth Heads of Government meeting in Durban.²⁹⁰

5.7 CONCLUSION

Besides international efforts, such as the corporate governance principles of organisations like OECD, recent surveys have identified well over hundred national corporate governance codes adopted by various organisations. One can add to this that there are seemingly endless corporate governance pronouncements by individual companies and organisations. These sets of rules, whether international, national, or company-specific, are all strangely similar. Yet corporate governance practices differ substantially across countries and companies. And there are still

²⁸⁹ OECD *Bank Group Policy on Good Corporate Governance* (1999)5

²⁹⁰ Bowes G T 'Corporate Governance in the Commonwealth' (1999) CACG 1

many concerns regarding the effectiveness of corporate governance rules in transition and developed countries, as well as many developed countries.

In other words, the written rules are not adhered to and pronouncements of SOEs are not being followed up by actions. In great part this is because rules and regulations are not enforced and increasingly policymakers have come to realise that enforcement more than regulations is the key problem, at least in transition and developing countries. For sustained development to take place, governance has to operate on many levels at the national level, local government level, the level of N.G.O.S. and at the corporate level.²⁹¹ SOEs have to operate within the overall policy framework set by Government. The rationale for State ownership of commercial enterprises is the belief that it is essential to provide important public services that would otherwise not be met from a purely financial or economic standpoint, as well as the belief in some quarters that they help to reduce inequalities and promote a fairer society.²⁹²

SOEs overall impact on economic performance and the application of good governance practices stands high on the agenda. Links between policy frameworks, corporate governance practices and economic outcomes, as well as the roles of policymakers and the SOEs respectively is of paramount important. Hence there is a great deal of work to be done and this will be addressed in the next chapter.

²⁹¹Wolfenden J, one time President of the World Bank

²⁹²OECD *Guidelines On Corporate Governance Of State-Owned Enterprises*.(2005) 23

CHAPTER SIX

"If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere."²⁹³

6. 1 Conclusion

The main objective of this research has been to draw attention to the potential importance or the impact of corporate governance reforms on better SOEs governance. An analysis of the history of South African SOEs, the form and effect of their reforms, the legal and regulatory framework of SOEs, ownership function, relationships with respective industry, the stakeholders and shareholder perspectives on corporate governance, the compliance with legislative prescripts, their performance, transparency and disclosure, and the role of the board of directors are amongst other topics that have been explored in this research. An overview of the governance structure and the role of the state over SOEs with reference to good corporate governance principles have also been examined. The interrogation of whether such reforms have inspired the improvement of corporate standards and behaviour has also been covered. Lastly the scrutiny of the positive and negative consequences that could strengthen the corporate governance regulations and assist in determining the best possible model for South African SOEs has also been probed.

Sketching the possibilities and limits of corporate reform in the current climate of crisis and change has been a learning exercise. What could have been done in the past and what can perhaps be done now, given the very different business experiences has assisted in providing the possible solutions. SOEs suffered the cost of poor corporate governance in the form of lower valuations, reduced access to equity finance, and difficulties with respect to succession planning and accessing outside talent. Equally, the economy has paid through reduced productivity, as investment funds were allocated less efficiently. If the situation is attended to that measure could play an important role in improving corporate governance arrangements. When codes and principles are used as a national standard or as an

²⁹³ Levitt A Former Chairman, US Securities and Exchange Commission, 2000

explicit substitute for legal or regulatory provisions, market credibility requires that their status in terms of coverage, implementation, compliance and sanctions is clearly specified.²⁹⁴

The regulatory reforms should not be used as an over-reaction or address symptoms of a problem while ignoring underlying causes as that can be costly and counter-productive. Government's role in restoring corporate integrity and market confidence without stifling the strength that underlies effective and efficient SOEs cannot be over-emphasised. The determinants of corporate governance compliance have revealed that the existence of corporate governance regulation is indeed a significant factor in company's compliance levels.

Despite South Africa's reforms aiming at achieving more transparent ownership and less "entrenched" management, the outcome in terms of the distribution of corporate power in the economy is mixed. It is generally assumed that a regulatory environment would result in enhanced corporate governance because companies are meant to comply with the relevant regulations, and the literature shows that regulation has a positive impact on corporate governance compliance. Regulation does enhance the quality of audited reports followed by organisational performance. The performance-governance relationship does depend on whether or not one takes into account the endogenous nature of the relation between governance and performance. The inter-relationships among corporate governance, management turnover, corporate performance, corporate capital structure, and corporate ownership structure suggest that there is a correlation of the relationship between corporate governance and performance.

The presence of an effective corporate governance system within SOEs helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. Numerous theories have been proposed on corporate governance best practice, none more popular are the shareholder and stakeholder theories. These theories have assisted in determining the best possible theory that can assist South Africa in tackling poor corporate governance as it has contributed largely to most SOEs failures, which have in turn posed significant public costs and

²⁹⁴ Harris M & Raviv A 'The Design of Securities' (1989) 24 *Journal of Financial Economics* 264.

consequences due to their impact on applicable systems and the broader macroeconomic implications, and that have also tainted risk and negative impact on their productivity. These concerns over South African SOEs corporate governance standards have been very clear and the status quo is no longer acceptable. The demand for accountability and responsibility in corporate behaviour goes without saying. Even though it will take more than just leadership to restore public confidence in South African SOEs in order to ensure their ongoing viability, effective government action in the form of robust monitoring or oversight role, independence of the auditing system, and stepped up law enforcement needs to be employed.

The stakeholder theory is ideal for South Africa in that it emphasises the need for the corporation to define in the broader sense the mere maximisation of shareholder welfare. The theory entails that managers should internalise all stakeholders' welfare in order to cater for their needs. The outcome should not only depend on the choices made by one person, but also on the strategies selected by other participating parties. Ethical treatment of stakeholders if consistently practised will benefit the SOEs because trust relationships are built with stakeholders. In order to achieve the maximum efficiency in the costs of social association the long-term contractual associations between a company and its stakeholders are necessary.

For sustainable development to take place, governance has to operate on all levels. State-ownership has to operate within the overall policy framework set by Government. The rationale for State ownership of commercial enterprises is that it is essential to provide important public services that would otherwise not be met from a purely financial or economic standpoint so that they help to reduce inequalities and promote a fairer society.

From the perspective of the political economy of corporate governance, the benefits of state ownership of 100 percent of a firm's equity holdings, as opposed to a lower threshold, are twofold. First there should be an elimination of the typical agency problems associated with multi-owners whole ownership neutralizes the government's interest and influence in most legal provisions that govern the internal affairs rules of corporations. Second the whole ownership creates superior incentives for the implementation of efficient corporate governance rules. The government has

an incentive to implement a legal regime that increases SOE firm value proposition in order to maximize its efficiency. In order to mitigate the state's conflicts of interest in corporate law-making the whole government ownership may in fact be preferable to partial ownership.

Uncovering the area where the interests of managers diverge from those of the interests of shareholders and the consequence has helped in suggesting that the State should clarify the function and ensure that each group should exercise within a governance structure. The State ownership function which is responsible for defining the ownership policy and high-level objectives for SOEs must be clearly articulated to avoid confusion. The board which is charged by the State with overseeing the development of a strategy to achieve the state's objectives and monitoring of progress must also be clear. The executive management who propose a strategy and who are accountable to the board for implementing the strategic plan must be given space to do that.

In view of the above the board is at the centre of the governance of the SOEs. As such it carries the ultimate responsibility for SOEs performance, and it has the authority and autonomy to make decisions that determine performance. It also acts as the intermediary between the State and the SOEs on behalf of the owners. They can only be able to do that if they are trusted and left to do just that.

6. 2 Recommendations

Having deliberated on the route that South African SOEs can follow in terms of redeeming its reputation taking in consideration the work that has been done in the previous five chapters, the following serve as recommendations for the purpose of this research:

- (a) The key strategy of providing the board of directors with greater powers and the autonomy to exercise their powers and to enhance board composition in order to ensure that they have the necessary skills to achieve their goals cannot be overemphasised. Ensuring the independence of board members including shielding them from political intervention will assist the proper functioning of SOEs. The manner in

which the government influences the course of SOEs should be looked at. CEO-Chair separation in most cases is significantly positively correlated with better coexistent and subsequent operating performance of SOEs.

- (b) Clarity on the State's ownership function in enhancing SOE boards to create a shared vision for the governance reforms that are to be achieved and to clearly communicate in line with the SOEs policies and objectives can better serve South Africa. This is another way of saying that reform of corporate governance has to be reasonable in the context of what is and not simply what ought to be, and resonant with larger social goals that enjoy broad support. How the ownership function of the State is organised can influence the overall investment environment. This function needs to be clearly identified and separated from other state functions, including regulatory oversight to help ensure a level playing field, especially with regard to complying with laws and regulations. It will also help to ensure that the State, while being an active and informed owner, does not interfere in the day-to-day management of SOEs, leaving their boards with operational autonomy to realise their defined objectives and fulfil their function of strategic guidance and monitoring of management.
- (c) Board members should be nominated through transparent processes, based on competencies and experience and should act in the best interests of the company as a whole, rather than as individual representatives of the constituencies that appointed them.²⁹⁵
- (d) While the objectives of good governance, namely creation, protection and equitable distribution of shareholder value, have long been recognized, their full achievement in practice has been dogged by challenges emanating from various sources like dominant shareholders, autocratic executive managements, ineffective independent auditors, inefficient enforcement mechanisms, and so on.²⁹⁶ Standing out prominently among these challenges is the potential for controlling shareholder dominance

²⁹⁵ OECD *Guidelines on Corporate Governance of State-Owned Enterprises* (2005) 21

²⁹⁶ Blair M M, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century*, (1995) 25

often abetted, unwittingly or otherwise, by inefficient board surveillance over the executive.²⁹⁷ What should happen is that there should be a clarity regarding the roles and responsibilities of the board, individual members, the chief executive officer and the Minister. Appropriate instruments should also be established to describe responsibilities for the board collectively and for individual members that conform to the public sector principles.

- (e) Another recommendation is to infuse SOEs with private sector discipline, competitive market pressures, and clear consequences for non-performance. This forces SOEs to meet their costs of capital and divest any activities that are not commercially viable. In restructuring the public sector to carry out national goals the balance of evidence will guide the decision for or against various economic policy measures. Government must therefore consider increasing the public sector in strategic areas through purchasing a shareholding in companies, establishing new public corporations or joint ventures with the private sector, and reducing the public sector in certain areas in ways that enhance efficiency while ensuring the protection of both consumers and the rights and employment of workers.
- (f) A high level of shareholder, manager and board of directors involvement in the decision making process should suggest the existence of active corporate monitoring and governance, which could in turn reduce agency problems and lead to improved enterprise performance. At the same time it should imply a lower relative level of state intervention. With regard to the control variables, it seems worth mentioning that none of the new formal organs of corporate governance established by new Companies Act seems to have a decisively positive influence on company performance. Ongoing efforts of South African authorities to improve internal corporate governance mechanisms therefore seem to be much in line with the current realities in its listed firms.

²⁹⁷ Blair M M, *Ownership and Control: Rethinking Corporate Governance for the Twenty -First Century*, (1995) 25

- (g) While ownership matters, policies and institutions matter just as much. For each transaction, proper planning, execution, monitoring, and assessment are necessary. Transparency is an integral part of corporate governance. It includes timely access to relevant information, respect for rule of law and procedures, as well as control. Lack of transparency often leads to allegations of corruption and loss of investor confidence. In this regards the State should be seen to foster economic growth through the creation of environmental conditions under which these SOEs should freely operate. Meddling into the day to day running of the SOEs reduces the SOEs to focus in achieving their mandate.
- (h) The government's involvement in the domains of personnel, financial and strategic SOEs' decisions yields negative and significant coefficients, suggesting a detrimental impact. The said should be left to the board of directors to appointment the suitable candidates for the job.
- (i) Well-designed training programmes for board members as well as the government ownership representatives enhances channels of communications between CEOs and the boards. As such this much be encouraged and practised.
- (j) The establishment and maintenance of a legal and regulatory framework for the governance and management of SOEs can serve as good environment that is conducive to them optimising their performance. This notion was supported by the Minister of Finance Mr Nhlanhla Nene who voiced out a concern that government lacks the legal instrument to properly intervene in the affairs of the state-owned companies when things go awry and made suggestion that a need has arisen to explore legislative changes in order to empower the state to exercise such interventions.²⁹⁸

²⁹⁸ Paton C 'State seeks stronger control over its entities' *Business Day* 22 October 2015

6.3 Future studies

Consideration of this governance measure by future accounting and finance researchers would enhance the comparability of these research findings.

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