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## TABLE OF CONTENT

Declaration	i
Dedication	ii
Acknowledgement	iii
Abstract	iv
Key words	v
Acronyms	vi
CHAPTER ONE	1
1.1.Introduction	1
1.2 Problem statement	4
1.3 Research question	5
1.4 Objectives of the research	5
1.5 Significance of the research	6
1.6 Methodology	8
1.7 The structure of the research	9
CHAPTER TWO	10
AN OVERVIEW OF GOOD CORPORATE GOVERNANCE	
2.1 Introduction	10
2.2 History of corporate governance	10
2.3 Definition of corporate governance	11
2.4 Structure and principles of corporate governance	14
2.5 Theories of corporate governance	19
2.6 Regulatory framework on corporate governance	25



2.7 Conclusion	29
CHAPTER THREE	31
AN OVERVIEW OF STATE–OWNED ENTERPRISES (SOES)	
3.1 Introduction	31
3.2 Establishment and roles of Eskom, Iscor, Sasol & Foskor	31
3.3 The situation analysis of the performance of existing SOEs	38
3.4 The role of the state as shareholder	40
3.5 Conclusion	43
CHAPTER FOUR	45
MEASURING THE EFFECTIVENESS OF CORPORATE GOVERNANCE	
4.1 Introduction	45
4.2 Compliance levels	45
4.3 The factors that influence the level of compliance	49
4.4 International Perspective	53
4.5 South African Perspective	57
4.6 Conclusion	58
CHAPTER FIVE	60
COMPARATIVE INTERNATIONAL EXAMINATION	
5.1 Introduction	60
5.2 Mandatory corporate governance regime	60
5.3 Voluntary corporate governance regime	63
5.4 Governance and value	66
5.5 Global initiatives on corporate governance	68

5.6 Corporate governance in commonwealth authorities and companies	70
5.7 Conclusion	70
CHAPTER SIX	72
CONCLUSION AND RECOMMENDATIONS	
6.1 Conclusion	72
6.2 Recommendation	75
6.3 Further research	78
BIBLIOGRAPHY	79



## DECLARATION

I declare that, **A Critical Review of Corporate Governance Reforms Relating to South African State-Owned Enterprises**; is my own work, has not been submitted before for any degree or examination in any other university, and that all the sources I have used or quoted have been indicated and acknowledged as complete references.

Lindiwe Portia Mekwe

Signed.....



Prof Riekie Wandrag

Signed.....

## DEDICATION

I dedicate this mini thesis to my husband, Sydney and my children, Tshego, Dikano and Tlotlo.



## KEY WORDS

Corporate Governance, Reforms, State Owned Enterprises / State Owned Entities, Escom/ Foskor/ Sasol and Iscor, Privatization process, Productivity analysis, Governance framework, Shareholder/stakeholder models





## ACRONYMS

ANC	African National Congress
CEO	Chief Executive Officer
CSR	Corporate Social Responsibility
DPE	Department of Public Enterprise
ECB	Electricity Control Board
ESCOM	Electricity Supply Commission
IDC	Industrial Development Corporation
IEC	East India Company
ISCOR	South African Iron and Steel Industrial Corporation Limited
FOSKOR	Phosphate Development Corporation
FSB	Financial Service Board
JSE	Johannesburg Stock Exchange
NGOS	Non- Governmental Organisations
OECD	Organization for Economic Cooperation and Development
PFMA	Public Finance Management Act
PRC	Presidential Review Committee
SASOL	South African Coal, Oil and Gas Corporation
SAPO	South African Post Office
SOE	State-Owned Entity
SOES	State-Owned Entities
U S A	United State of America
U K	United Kingdom

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## ABSTRACT

Corporate governance reform is an important aspect of broader reforms aimed at securing an environment attractive to both domestic and foreign investors and that enhances the benefits of investment to society. Of particular relevance is the relation between corporate governance practices and the increasingly international character of investment. If a country decides to reap the full benefits of the global capital market, and if it decides to attract long-term patient capital, good corporate governance arrangements must be credible, well understood across borders and adhere to internationally accepted principles.

Equally important is the underlying importance of institution building for developing countries. In most cases poverty goes hand in hand with the lack of proper institutions, a vicious circle of mismanagement, inefficiencies, expropriation and corruption. The lack of properly functioning State Owned Enterprises (SOEs) as institutions or corporations, impacts directly on growth by limiting the availability of debt and equity investment. It also impacts on the distribution of income within a society. With more transparency and accountability the directors and executives will have less of an opportunity to fatten their bank accounts at the expense of all the other stakeholders and the society as a whole.

The review of corporate governance reforms done in this research includes statutory reforms, development of codes of conduct and best practice, and institutional reforms will give a better evaluation of South Africa's corporate governance reforms within its own SOEs structures that will be judged against internationally accepted standards to consider the best interests of South Africa and its citizens. The positive and negative consequences that can stem from strengthening corporate governance regulations and assist in determining the best possible model for South African SOEs will form part of the recommendations of this research.

## CHAPTER ONE

### 1.1 Introduction

The main aim of the government of South Africa in establishing a large number of State Owned Enterprises (SOEs) or state corporations since 1920 was to shape the country's economy. The primary goal of this establishment was to strengthen the import-substitution industries which started to grow during World War I, by providing infrastructure improvements and basic materials.<sup>1</sup> The Electricity Act, No 42 of 1922 created two institutions i.e. the Electricity Control Board (ECB) and the Electricity Supply Commission (Escom). Escom was given statutory powers to establish generation and distribution undertakings to supply electricity at the lowest possible cost.<sup>2</sup>

In 1927 the Pact government (coalition between the National Party and the Labour Party) enacted new legislation, which led to the creation of the state-owned South African Iron and Steel Industrial Corporation Limited as it was known as in Afrikaans, *Suid Afrikaanse Yster and Staal Industriële Korporasie*.<sup>3</sup> The new company, which adopted Iscor as the shortened form of its name, quickly took control of the country's nascent steel industry including USCO's Vereeniging site and later Newcastle Iron and Steel Works as well.<sup>4</sup> Iscor at the outset was controlled by English-speakers and moderate Afrikaners not affiliated with National Party.<sup>5</sup>

Another State Own Enterprise (SOE) that followed suit was "the South African Coal, Oil and Gas Corporation (Sasol) which was established in 1950 as part of the process of industrialization that the South African government considered essential for its economic development and autonomy".<sup>6</sup> The fact that South Africa had no domestic oil reserves made the country extremely vulnerable to disruption of supplies coming from outside, albeit for different reasons at different times.<sup>7</sup>

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<sup>1</sup> US library of Congress 'Role of Government' <http://countrystudies.us/south-africa/63.htm> ( accessed 10 March 2015)

<sup>2</sup> Ebarhard A 'The political economy of power sector reform in South Africa, working paper # 6' <http://www.gsb.uct.ac.za> (accessed 10 March 2015)

<sup>3</sup> Pederson J P 'International Directory of Company Histories Vol. 57' <http://www.Fundinguniverse.com/company-histories/iscor-limited/> (accessed 10 March 2015)

<sup>4</sup> Pederson 2004 107

<sup>5</sup> Pederson 2004 108

<sup>6</sup> Pederson JP 'International Directory Of Company Histories' <http://www.Fundinguniverse.com/company-histories/sasol-limited/> (accessed 10 March 2015)

<sup>7</sup> Pederson J P ' International Directory of Companies Histories' <http://www.Fundinguniverse.com/company-histories/sasol-limited/> (accessed 10 March 2015)

Again in 1951, the South African government's Industrial Development Corporation (IDC), the state-owned financing institution, created another company called Foskor (then "*Fosfaat Ontginnings Korporasie*").<sup>8</sup> What began as a single mining operation with the sole purpose to make South Africa independent from any phosphate imports, has spent the past 50-plus years quickly growing and developing into a reputable and highly profitable producer and processor of phosphate rock concentrate, phosphoric acid and granular phosphate based fertilizer.<sup>9</sup>

During those periods the majority of corporate directors were appointed by the National Party government whilst the appointment of personnel working for these state owned enterprises were left to senior management to make decisions independent of government control.<sup>10</sup> The government's primary control over state corporations was by granting or withholding loans of state money. The electricity state owned enterprise, Eskom, was however allowed to raise money publicly, but most other state owned enterprises relied on government funds for capital funding.<sup>11</sup>

By 1980 poor economic performance of State-Owned Enterprises, combined with broader economic and political pressures on the apartheid state, caused government to look at reforming these institutions.<sup>12</sup> The National Party government had partially given up the notion of import-substitutional development and tried to achieve economic development through export – orientated industry.<sup>13</sup> This led to "the intention to start the privatization process in South Africa as was first announced by the former State President, P. W. Botha on the 5<sup>th</sup> of February 1988".<sup>14</sup> The first four public enterprises that were identified for privatization were South African Iron and Steel Industrial Corporation Limited (Iskor), Phosphate Development Corporation (Foskor), the South African Transport Services (later known as Transnet) as well as the South African Post Office (SAPO) and Telecommunication (Telkom) Services.<sup>15</sup> The public view on the President's announcement was that the large foreign loans were called in and cut off in 1985 and left the State corporations with serious capital

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<sup>8</sup> The African Business Journal 'Foskor' [http://www.tabj.co.za/mining/foskor\\_sa.html](http://www.tabj.co.za/mining/foskor_sa.html) (accessed 09 March 2015)

<sup>9</sup> The African Business Journal 'Foskor'

<sup>10</sup> US library of Congress 'Role of Government' <http://countrystudies.us/south-africa/63.htm> (accessed 10 March 2015)

<sup>11</sup> US library of Congress 'Role of Government'

<sup>12</sup> Eberhard A 'The political economy of power sector reform in South Africa', working paper # 6' <http://www.gsb.uct.ac.za> (accessed 10 March 2015)

<sup>13</sup> Watkins t, Valley S & Alley T 'Privatization in South Africa under the Nationalist Party Government' <http://www.applet-maic.com/southafrica.htm> (accessed 12 March 2015)

<sup>14</sup> Parker D and Saal D *International Handbook on Privatization* (2003) 293

<sup>15</sup> Parker D and Saal D 2003 293

shortages. This was also viewed as a strategy by international communities to force the National Party government to reform their political landscape.<sup>16</sup>

The transition to democracy in the 1990s forced Sasol to search for products that could prove more competitive in the global marketplace, and as of the new millennium Sasol is focusing primarily on its petrochemical business, as well as on efforts to convert natural gas into crude oil.<sup>17</sup> Deregulation and the end of government protection made it clear that the company would no longer be able to survive on the profits from its synthetic fuel business.<sup>18</sup> In 1995 Sasol joined forces with the German chemicals firm Schumann, giving the joint company control over one-fifth of the international wax market, and its 1998 acquisition of AECI made it the third largest producer of explosives in the world.<sup>19</sup>

It was only in 2004 that a firm decision was taken by South African government to retain ownership of key SOEs and those SOEs were given strategic economic mandates by the state to guide their strategies and business plans.<sup>20</sup> Infrastructure SOEs were also instructed to establish aggressive investment programmes. These were later expanded upon to support the needs of a growing economy, rather than what their balance sheets could comfortably accommodate.<sup>21</sup> This took place in the absence of any formal government policy relating to the role of SOEs or their capitalisation.

Malherbe and Seagal drew the conclusion that the context of South African corporate business until 1994, had a decisive impact on economic developments in South Africa.<sup>22</sup> The issue of access to capital markets, as well as the efficient use of capital by firms in the economy was central and the structure of the corporate firm has an impact on corporate governance and therefore the reform of legislation and

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<sup>16</sup> Parker D and Saal D *International Handbook on Privatization* (2003) 293

<sup>17</sup> Pederson JP 'International Directory Of Company Histories' <http://www.Fundinguniverse.com/company-histories/sasol-limited/> (accessed 10 March 2015)

<sup>18</sup> Pederson JP *sasol-limited*

<sup>19</sup> Pederson JP *sasol-limited*

<sup>20</sup> Ritchken E 'The Evolution of State Owned Enterprises in South Africa' *Workshop on State-Owned Enterprises in the Development Process* (2014) 2

<sup>21</sup> Ritchken E 2014 2

<sup>22</sup> OECD *Development Centre Corporate Governance in Developing Economies and Emerging Economies* (1999) 2

regulations, listing rules and accounting standards play an important role in corporate governance reform.<sup>23</sup>

The current picture of the corporate governance situation in South Africa shows that the country is receiving international recognition for its high standards of corporate governance while at the same time observers raise serious concerns about corruption and the rule of law.<sup>24</sup> On the other hand SOEs straddle the divide between a corporate and public environment, and therefore have their very own dynamics.<sup>25</sup> It is for this reason that the critical issue to be touched upon is the evaluation of corporate governance reforms that took place within South African SOEs to describe its key features and whether the reforms by its nature improved the performance of these SOEs.

An analysis of the major corporate governance reforms is done in this research including statutory reforms, development of codes of conduct and best practice and institutional reforms. The global principles of corporate governance are examined concerning how they can serve as models for enhancing corporate governance standards in South African SOEs. The analysis is based on the need to evaluate South Africa's corporate governance reforms within its SOEs structures against internationally accepted standards to consider the best interests of South Africa and its citizens.

## 1.2 Problem statement

Different opinions that arose, the political aspects involved, the strategy pursued to promote the reform, and the model that finally prevailed had a bearing in the shape and form of corporate governance within SOEs. The cultural changes in the business and financial community that came with the implementation of the new regulation and the principal effects that the new legislation had on the South African market had a great deal of impact in the management of the SOEs.

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<sup>23</sup> Diamond G & Price G *The political economy of corporate governance reform in South Africa* (2010) 57

<sup>24</sup> Centre for Corporate Governance in Africa. *Rating corporate governance of state owned enterprises report*. (2012) para 1

<sup>25</sup> Centre for Corporate Governance in Africa. 2012 para 3



Following the end of apartheid, several corporate governance-related reforms took place to promote more transparent corporate ownership.<sup>26</sup> Legislation was enacted regarding insider trading, multiple directorships and director liability. Self-regulation also played a role in modernising the corporate governance framework. The first version of the King Code on corporate governance was released in 1994, constituting at the time a real innovation for an emerging economy.

The empirical tests show that better corporate governance is highly correlated with better operating performance and market valuation.<sup>27</sup> The manner in which SOEs relates to other stakeholders, how they fulfill their obligations and how they report on the performance will also form part of this research.

### 1.3 Research question

The main reason for this research is to determine whether the shareholder value proposition as a means for corporate governance reforms will provide the best framework for governing these SOEs in South Africa?

### 1.4 Objectives of the research

The main objectives of this research are to:-

- (a) Draw attention to the potential importance or impact of better SOEs governance;
- (b) Analyse the legal and regulatory framework of SOEs, ownership function, relationships with respective industry, the stakeholders and shareholder perspectives on corporate governance, their compliance with legislative prescripts, their performance, transparency and disclosure, and the role of the board of directors;
- (c) Provide an overview of the powers of governance organs within SOEs with reference to good corporate governance principles;

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<sup>26</sup> Hubbard P *Corporate Governance in South Africa* ( 2010) 12

<sup>27</sup> Klapper L. F & Love I *Corporate Governance, Investor Protection, and Performance in Emerging Markets*,(2002) 2818



- (d) Interrogate whether such reforms did inspire the improvement of corporate standards and behaviour; and
- (e) Scrutinise the positive and negative consequences that can stem from strengthening corporate governance regulations and assist in determining the best possible model for South African SOEs.

### 1.5 Significance of research

In evaluating this topic the following issues will be taken into consideration, the contrast between shareholder and stakeholder models, and the divergence between U.S. and U.K. approaches to corporate governance locating a South African approach in context of the Anglo-American model. The King reports and whether a possible “African” model of corporate governance can emerge, and the role of international and domestic factors in shaping South Africa’s ongoing reform process will be examined.

Some of the available literature has revealed that corporate governance of SOEs including research work that has been conducted by the Centre of Corporate Governance in Africa has confirmed the need to improve the governance structures, processes and mechanisms existing in SOEs. It is against this backdrop that a research on this topic from those sources will provide a possible remedy for good corporate governance for SOEs.

The research proposes to link corporate governance to productivity analysis within SOEs. Productivity considers how the entities are efficient in maximising outputs from inputs. Using productivity measures to examine whether good corporate governance mechanisms improve capacity utilisation and growth is therefore relevant.<sup>28</sup>

Four SOEs that were established since 1920, that is Escom which was established in 1920, Iscor which was established in 1927; Sasol which was established in 1950 and Foscor that was also established in 1951, had a responsibility of infrastructure

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<sup>28</sup> Nanka-Bruce D *Corporate Government, Capacity Utilisation and Growth* (published Doctoral Thesis, University of Barcelona, 2006) 33

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.

## 1.6 Methodology

Given that this research will examine the corporate governance reforms in South African SOEs, it is logical to state that this research is exploratory in nature. Many variables are not known in regard to the success of some of these SOE's corporate governance practices especially with regards to their relationship with shareholders and their governance structures.

Using a qualitative approach incorporating case study, legislation, journals, articles and written research papers is essential in analyzing the processes in the corporate governance. The goal is to find the success factors of the holding company model and see the applicability of the context to South Africa.

The comparative analyses of the history, rationale and significance of the reform, the scale and scope of the SOE with other countries such as USA, UK and Organisation for Economic Co-operation and Development (OECD) member countries, is vital to obtain an overall overview on the implementation and execution of the principles used to serve as a context for South African analysis.

## 1.7 The structure of the research

The research is broken down into six chapters. The first Chapter which is the introduction focuses on problem statement, research objective, significance of research and research methodology in order to present the purpose statement of the research. Chapter two covers the overview of good corporate governance which entails definition of corporate governance, structure and principles of corporate governance, theories of corporate governance, shareholder and stakeholder perspective of corporate governance and current regulatory framework on corporate governance. Chapter three present an overview of the SOEs which covers the establishment and role of SOEs, performance of these SOEs and the role of the State as shareholder to provide .Chapter four focuses on code for compliance as a measure of good corporate governance. The compliance levels, determinants of

compliance levels, international evidence and South African evidence are part of the discussions under Chapter four. Chapter five gives a comparative international examination with an analysis of the divergence between U.S. and U.K. approaches to compare it with South African approach. Chapter six concludes the research and recommendations are then proposed in this chapter.



## CHAPTER TWO

### OVERVIEW OF GOOD CORPORATE GOVERNANCE

*“With the wave of impressive corporate financial scandals of the 1980s and 1990s, corporate governance codes were designated as a response to encourage company managers, shareholders, stakeholders and controlling agencies to mind their corporate etiquette in order to prevent or, at least lessen the impact of such scandals in the future.”* Bas Steins Bisschop<sup>29</sup>

#### 2.1 Introduction

Good Corporate governance promotes fairness, openness, and transparency in its responsibilities to stakeholder, inherently corporate governance practices facilitates economic efficiency by focusing on value-enhancing activities and aids efficient allocation of scarce resources.<sup>30</sup> This is achieved when corporations efficiently employ their assets, attract low cost capital, meet societal expectations and improve overall performance.

Corporate governance matters a lot for national development especially in developing countries as it has the potential to increase the economic growth of the country. The focus on the deliberation of the history of corporate governance in this chapter is to understand the evolution of corporate governance in bringing about meaningful change in the society within which we live. The definition of corporate governance as another topic of the discussion will be focused in understanding the different models of corporate governance which can best suit South Africa. The analyses of the structure and essential principles of corporate governance, which affects the process, systems, practices and procedures that are used to determine corporate direction and performance, will be discussed in this chapter. Examination of the formal and informal rules that govern institutions, the manner in which these rules and regulations are applied and followed will help to achieve the desired objectives of this research.

#### 2.2 History of corporate governance

The history of corporate governance correspondingly extends back at least to the formation of the East India Company, the Hudson’s Bay Company, the Levant Company and the other major chartered companies launched in the 16<sup>th</sup> and 17<sup>th</sup>

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<sup>29</sup> Bisschop B S *Integrity and transparency as fundamental notions of Good Governance but are they enforceable* (2014) 1

<sup>30</sup> Mohamad S & Sori Z M ‘An overview of corporate governance: some essentials’(2011) [http. www.ssrn.com](http://www.ssrn.com) (accessed 10 March 2015)

centuries.<sup>31</sup> The East India Company (EIC) was a precursor of the modern corporation working in a globalized world.<sup>32</sup> The corporate model which emerged during the early years of the EIC is of a collective of trader-investors who combined their efforts and resources to seek common economies of scale beyond their individual reach.<sup>33</sup> The members elected some of their own as officers to manage the day to day affairs reporting to the governing body of the General Court.<sup>34</sup> The manner in which the said companies were managed is a result of a set of habits, procedures, and techniques that were developed at the time, being linked to a nation's culture and society. Nick Robins confirms that the East India Company pioneered the model of the corporation that we see today. He further states that its innovations included the shareholder model of ownership, and the administrative framework of the modern firm.<sup>35</sup>

In South Africa, the King Report or "King I" or "codes" on Corporate Governance was the report that first institutionalised and published the concept of Corporate Governance in South Africa in 1994. The said report established and recommended standards of conduct for boards and directors of listed companies, banks and certain state-owned enterprises and emphasised the need for companies to become a responsible part of the society in which they operate.<sup>36</sup> This report offered to companies and state-owned enterprises, for the first time, a coherent and disciplined governance framework that was relevant to local circumstances and offered practical guidance.<sup>37</sup> The King Committee has no official mandate (unlike nearly all other similar initiatives in other countries), and thus its recommendations are self-regulatory.<sup>38</sup>

### 2.3 Definition of corporate governance

There is no single accepted definition of corporate governance. Humera Khan defines corporate governance as the broad term that describes the processes, customs, policies, laws and institutions that directs the organizations and

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<sup>31</sup> Cheffins B R *The Oxford Handbook of Corporate Governance* (2013) 46

<sup>32</sup> Dodija D *Emergence of Corporate Contract Set, Governance and Accountability* (2008) 2

<sup>33</sup> Dodija D 2008 2

<sup>34</sup> Dodija D 2008 35

<sup>35</sup> Robins N *The corporation that changed the world* (2006) 19

<sup>36</sup> Ramani Naidoo *An essential guide for South African companies* (2002) 2

<sup>37</sup> Armstrong P , Segal N & Davis B *Corporate Governance South Africa, a pioneer in Africa* (2005) 14

<sup>38</sup> Armstrong P , Segal N & Davis B 2005 14

corporations in the way they act, administer and control their operations.<sup>39</sup> He adds to say that corporate governance also enhances the long term shareholder value by the process of accountability of managers and by enhancing the firm's performance.<sup>40</sup> Khan's conclusion is that the effective corporate governance reduces the ownership and control problems and draws a clear line between the shareholder and manager.<sup>41</sup>

Dr Elaine Sternberg gives a definition of corporate governance very much in favour of a shareholder perspective. She defines corporate governance as the mechanism by which corporate actions, assets and agents are directed at achieving corporate objectives established by the corporation's shareholders.<sup>42</sup> She went further to distinguish different forms of corporate governance, audit procedures, information disclosure requirements that are appropriate for different forms of organisation.<sup>43</sup> Ultimately, it is the responsibility of the shareholders to ensure that the management use the assets of the company to fulfil corporate objectives.<sup>44</sup>

Sir Adrian Cadbury defines corporate governance as the system by which companies are directed and controlled.<sup>45</sup> In terms of this definition, the main objective of corporate governance is to ensure that the investments of those who supply a company with finances are increased exponentially. Therefore, the extent of a shareholder's interest in a company is determined by the amount of shares which he or she holds in the company.<sup>46</sup> This also means that when a director engages in corporate decision making, the director is only obliged to consider the interest of shareholders, disregarding the interest of other stakeholders, which include employees and suppliers. This approach to corporate governance is considered to be the narrow approach to corporate governance.<sup>47</sup>

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<sup>39</sup> Khan H A *literature review of corporate governance* (2011) 1

<sup>40</sup> Khan H A *literature review of corporate governance* (2011) 1

<sup>41</sup> Khan H A *literature review of corporate governance* (2011) 4

<sup>42</sup> Sternberg E *Corporate Governance Accountability in the Marketplace* (2004) 10

<sup>43</sup> Sternberg E *Corporate Governance Accountability in the Marketplace* (2004) 11

<sup>44</sup> Sternberg E *Corporate Governance Accountability in the Marketplace* (2004) 11

<sup>45</sup> Cadbury A *Committee on the Financial Aspects of Corporate Governance Final Report and Code of Best Practice* (1992) par 2.5

<sup>46</sup> Mongalo T 'Self Regulation versus Statutory codification: Should the new regime of corporate governance be accorded statutory backing?' (2004) *Journal of Contemporary Roman Dutch Law* 265

<sup>47</sup> Mongalo T 'Self Regulation versus Statutory codification: Should the new regime of corporate governance be accorded statutory backing?' (2004) *Journal of Contemporary Roman Dutch Law* 266

Ramani Naidoo defines corporate governance as an essential practice by which companies are managed and controlled.<sup>48</sup> That encompasses the creation of an ongoing monitoring of a system of checks and balances to ensure a balanced exercise of power within a company, the implementation of a system to ensure compliance by the company with its legal and regulatory obligations, the implementation of a process whereby risks to the sustainability of the company's business are identified and managed within agreed parameters and the development of practices which make and keep the company accountable to the broader society in which it operates.<sup>49</sup> In defining corporate governance, she includes responsible leadership as essential to corporate governance and as such leadership includes being transparent, answerable and accountable towards the company's stakeholders. She continues to emphasise that corporate governance aims at achieving a balance between economic, social, individual and collective goals, seeking to align as closely as possible the interests of individuals, the company and society as a whole.<sup>50</sup> Her definition of corporate governance leans towards stakeholder model meaning that the firm's overall performance does not only result from the particular power of the groups or individuals. The firm will perform well if all the stakeholders are satisfied and gratified for their contribution to the firm's overall performance.

Failed energy giant Enron, and its bankrupt employees and shareholders, is a prime argument for the importance of solid corporate governance. Sound corporate governance reduces risk, adds value to investments, and avoids reputational risks for investors. Aspects of corporate governance are the rights of shareholders and other interest groups such as the employees, how powers are shared and exercised by the directors, and how the holders of powers in a company should be held accountable for their omissions and actions.<sup>51</sup>

The perceived cost of good corporate governance practices justifies the results.<sup>52</sup> The concerns about the perceived cost of good corporate governance is a growing consensus that good corporate governance improves the long-term sustainability of

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<sup>48</sup> Naidoo R *An essential guide for South African companies* (2002) 1

<sup>49</sup> Naidoo R 2002 1

<sup>50</sup> Naidoo R 2012 2

<sup>51</sup> Kneale C *Corporate Governance in South Africa* (2012) 4

<sup>52</sup> Wiese T *Corporate Governance in South Africa with International Comparisons* (2014) 5



companies by reducing risks and increasing access to capital.<sup>53</sup> That basically means the presence of an effective corporate governance system, within SOEs or private companies across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. An increase of shareholder activism and public demand for accountability require that companies have good corporate governance procedure in place.<sup>54</sup> Poor corporate governance can contribute to SOEs failures, which can in turn pose significant public costs and consequences due to their potential impact on any applicable systems and the possibility of broader macroeconomic implications, such as taint risk and negative impact on their productivity.

## 2.4 Theories of corporate governance

The theory of corporate governance is frequently described in terms of two apparently opposing models which are the shareholder and stakeholder models.<sup>55</sup> The difference between these two models reflects different theories of the corporation. Shareholder theory was originally proposed by Milton Friedman when he stated that the sole responsibility of business is to increase profits.<sup>56</sup> This theory is based on the premise that management is hired as the agent of the shareholders to run the company for their benefit, and therefore they are legally and morally obligated to serve their interests. He continues to say that there is one and only one social responsibility of business to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.<sup>57</sup> Friedman's statements reflect three fundamental assumptions that lend support to the shareholder view of the firm. The first is that the human, social, and environmental costs of doing business should be internalized only to the extent required by law. All other costs should be externalized. The second is that self-interest as the prime human motivator. As such, people and organizations should and will act rationally in their own self-interest to maximize efficiency and value for society. The third is that the firm is fundamentally a nexus of contracts with primacy

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<sup>53</sup> Wiese T *Corporate Governance in South Africa with International Comparisons* (2014)5

<sup>54</sup> Wiese T (2014)5

<sup>55</sup> Donaldson T & Preston L E 'The Stakeholder theory of corporation: concepts, evidence and implications' (1995) 20(1)*Academy of Management Review* 65

<sup>56</sup> Friedman, M. 'The social responsibility of business is to increase its profits'. *N.Y. Times, Section 6*, (1970) 30

<sup>57</sup> Friedman, M. 'The social responsibility of business is to increase its profits'. *N.Y. Times, Section 6*, (1970) 30



going to those contracts that have the greatest impact on the profitability of the firm.<sup>58</sup>

The shareholder theory also found expression in the case of *Dodge v Ford Motor Company*, whereby the shareholder value was highlighted by the Court as a business corporation is organized and carried on primarily for the profit of stockholders.<sup>59</sup> With the primary emphasis on the stockholders' interest, the managers were censured for not meeting the requirement of operating the company as a business corporation according to the charter. The concept of shareholder value theory, also known as "shareholder primacy theory" or "shareholder wealth maximization" has been pervasive and determined as the aim of large public corporations, certainly as prominence since 1970s.<sup>60</sup> The shareholder value has been created to protect the remuneration of shareholders who are considered as the real owners of companies. As "the shareholders receive residual earnings in the form of dividends by virtue of their contract" which may be reinvested in companies, nonetheless, the share might come back to the central agent not by its origin.<sup>61</sup>

On the other hand, this also links to the agency theory which is radically discerned that "the managers or directors are agents for the investors or shareholders as beneficiaries or principals" since they are conferred with the principals' money and powers to generate profits and increase the value of investment for their investors.<sup>62</sup> Nevertheless, in practice, it hardly implies that the objective of the company is to manage in the exclusive interest of its shareholders.<sup>63</sup> Since the objectives and targets of the shareholders and the benefits of the managers may be in conflict, naturally the managers may make decisions that benefit them the most which may not be the most profitable choice for their investors.

Berle also argues in favour of the shareholder primacy norm. He stated that directors hold the property of shareholders in trust for the sole benefit of the stakeholder debate and directors' fiduciary duties. The exclusive obligation of directors was

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<sup>58</sup> Friedman, M. 'The social responsibility of business is to increase its profits.' *N.Y. Times, Section 6*, (1970) 30.

<sup>59</sup> *Dodge v. Ford Motor Company* (170 N.W.668, 664. Mich. 1919) 370

<sup>60</sup> *Dodge v Ford Motor Company* (170 N W 668, 664 Mich 1919) 370

<sup>61</sup> Aglietta M & Reberioux A, *Corporate Governance Adrift: A Critique of Shareholder Value* (2005) 33

<sup>62</sup> Simpson J and Taylor J *Corporate Governance Ethics and CSR* (2014)25

<sup>63</sup> Aglietta M & Reberioux A *Shareholder value and corporate governance: some tricky questions*, *Economy and Society* (2005)34

therefore the maximisation of shareholders' property.<sup>64</sup> He based his argument of trusteeship on the fact that shareholders are owners of a company. Director's obligations to shareholders are based on their role as trustees or agents of the shareholders. He therefore classified a company in terms of the separation of ownership and control.

The shareholder theory is now seen as the historic way of doing business with companies realising that there are disadvantages to concentrating solely on the interests of shareholders.<sup>65</sup> The role of the shareholder theory can be seen in the demise of corporations such as Enron and Worldcom where continuous pressure on managers to increase returns to shareholders led them to manipulate the company accounts.<sup>66</sup> In summing up the dominant views on corporate governance and courses of most business schools support the perspective that the sole purpose of business in our community is profit. Business acting beyond its economic concerns is at best misguided and is misallocating and/or misappropriating societal resources.<sup>67</sup>

Many of the more strident critics of the shareholder theory seem to claim that as executives are charged with maximizing shareholder value and are given large incentives to do so through stock options or other schemes, they will respond by embracing whatever manipulations are necessary to achieve that goal.<sup>68</sup> But the theory clearly dictates that the pursuit of profits should be done legally and without deception, and there is little wiggle room for the kinds of overtly illegal behavior alleged in many recent financial scandals.<sup>69</sup>

The shareholding corporate governance model is usually common in the UK, US and other commonwealth countries. Central to the shareholding corporate governance model is the doctrine of shareholder value and primacy.<sup>70</sup> It suggests that a firm must be run to primarily advance the interests of its owners. This is based on a basic assumption that ownership is separate from control in an Anglo-American mode. In this corporate governance system, the providers of capital (owners/shareholders)

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<sup>64</sup> AA Berle 'For Whom Corporate Managers are Trustees: A Note' (1932) 45 *Harvard Law Report* 1365

<sup>65</sup> Corp Admin 'Shareholder & Stakeholder Corporate Governance' <http://www.corplaw.i.e/blog/> (accessed 12 May 2015)

<sup>66</sup> Corp Admin 'Shareholder & Stakeholder Corporate Governance' <http://www.corplaw.i.e/blog/> (accessed 12 May 2015)

<sup>67</sup> Easterbrook, F. H., & Fischel, D. R. *The economic structure of corporate law* (1991) 25.

<sup>68</sup> Smith, A. *An inquiry into the nature and causes of the wealth of nations* (1981) 31

<sup>69</sup> Smith, H. J 'The shareholders vs. stakeholders debate.' , (2003) 44(4)*MIT Sloan Management Review* 85

<sup>70</sup> Schwartz D E 'Shareholder Democracy: A Reality or Chimera' (1983)*California Management Review* 53

surrender the day-to-day management (control) of the business to a group of managers consisting of a 'unitary' board of directors and executive management, who are frequently not owners of the corporation themselves. Of close relevance is that through multiplicity of shareholders, ownership in this corporate governance model is quite often relatively widely diffused.<sup>71</sup>

A major implication from dispersed ownership is that the power of shareholders to exercise control over the way their business is run is greatly impaired.<sup>72</sup> This raises the agency problem. However, the agency theory suggests that since shareholders (principals) have to delegate the control of their business to a few directors and managers (agents) to run the company on their behalf, there is a potential risk that directors and managers will pursue their own interests to the detriment of the eventual owners' shareholders.<sup>73</sup> By contrast, the shareholding model rejects external interventions and additional obligations imposed on corporations by government and central authorities because it may distort free market operations. This implies that shareholders can easily either transfer their capital from a poorly-governed company to a better-governed one or a poorly-governed company may be acquired by a better-governed firm through the inherent efficient markets for corporate control.

The shareholding model suffers from several weaknesses generally concerning shareholder power and democracy, stakeholder interests, social morality and ethics, efficient factor markets, and excessive short-termism.<sup>74</sup> Sternberg suggests that because executive directors of a corporation are also normally its managers, they are less willing to recognise, criticise or correct their own mistakes. Non-executive directors' accountability to shareholders is also usually impaired by the ways in which they are nominated, officially appointed and remunerated.<sup>75</sup>

On the other hand, stakeholder theorists have criticised the shareholding model on two main grounds, firstly that it ignores the social, ethical and moral responsibilities of the corporation as an important societal institution; and that it offers a narrow

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<sup>71</sup> Berle A and Means G *Background and Perspectives on Corporate* (1932) 7

<sup>72</sup> Blair M *Ownership and control: rethinking corporate governance for the twenty-first century* (1995) 4

<sup>73</sup> Smith, A. *An inquiry into the nature and causes of the wealth of nations* (1981) 3

<sup>74</sup> Blair M *Ownership and control: rethinking corporate governance for the twenty-first century* (1995) 6

<sup>75</sup> Sternberg E *Corporate Governance: Accountability in the Marketplace* (2004) 4

definition of the stakeholders of the firm.<sup>76</sup> The stakeholder theorists argue that rather than running the firm to primarily maximise the wealth of shareholders<sup>77</sup>, the firm should equally serve the interests of a wider stakeholder group.<sup>78</sup>

Edward Freeman, the original proposer of the stakeholder theory, affirms it as an important element of Corporate Social Responsibility (CSR), a concept which recognises the responsibilities of corporations in the world today, whether they be economic, legal, ethical or even philanthropic.<sup>79</sup> According to the stakeholder theory, managers are agents of all stakeholders and have two responsibilities: to ensure that the ethical rights of no stakeholder are violated and to balance the legitimate interests of the stakeholders when making decisions.<sup>80</sup>

The stakeholder theory of corporate governance is often found in France, Germany, Japan and other European or Asian countries. A central underlying assumption of the stakeholding corporate governance model is that the purpose of the corporation is to maximise the welfare of a number of stakeholders of the firm rather than those of shareholders alone.<sup>81</sup> They suggest that a firm consists of social groups in which each group can be seen as supplying the firm with important resources (contributions) and in return expects its interests to be promoted. For example it is suggested that shareholders supply the firm with capital. In exchange, they expect to maximise the risk-adjusted return on their investments. Creditors provide the firm with loans. In return, they expect their loans to be repaid on time. Local communities supply the firm with location and local infrastructure. In exchange, they expect the firm to improve their quality of life. Managers and employees provide the firm with time and skills. In return, they expect to receive a sustainable income, and this has been argued to be true for every reasonably conceivable constituency of the firm.<sup>82</sup>

The theory states that a company owes a responsibility to a wider group of stakeholders, other than just shareholders.<sup>83</sup> A stakeholder is defined as any person/group which can affect/be affected by the actions of a business. It includes

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<sup>76</sup> Blair M *Ownership and control: rethinking corporate governance for the twenty-first century* (1995)2

<sup>77</sup> Freeman R E and Reed D L *Stockholders and Stakeholders: A New Perspective on Corporate Governance* (1983) 25

<sup>78</sup> Berle A and Means G *Background and Perspectives on Corporate* (1932) 8

<sup>79</sup> Freeman R E, *Managing for Stakeholders. In Ethical Theory and Business* (2009)8th Edition 56

<sup>80</sup> Smith, H. J 'The shareholders vs. stakeholders debate'(2003) 44(4)*MIT Sloan Management Review*, 85

<sup>81</sup> Blair M M *Ownership and control: rethinking corporate governance for the twenty-first century* (1995) 7

<sup>82</sup> Hill CWL and Jones TM *Stakeholder-Agency Theory Journal Management Studies* (1992) 134

<sup>83</sup> Corp Admin 'Shareholder & Stakeholder Corporate Governance' <http://www.corplaw.i.e/blog/> (accessed 12 May 2015)

employees, customers, suppliers, creditors and even the wider community and competitors.<sup>84</sup>The fundamental distinction is that the stakeholder theory demands that interests of all stakeholders be considered even if it reduces company profitability. Recognition of stakeholder concern is not only good business, but politically expedient and morally and ethically just, even if in the strict legal sense they remain directly accountable only to shareholders.<sup>85</sup>

There is a growing awareness that ownership, control and the monitoring of management of business organisations are significant variables in explaining firm performance and in the protection of stakeholders. This was echoed by Dodd when he argued that directors serve as trustees for the entire community rather than for shareholders only. Therefore, directors should use the company's resources to address the interests of a wider variety of stakeholders. By doing so, directors would behave in a socially responsible manner.<sup>86</sup>

Hawley & Williams went further in their literature review of corporate governance which was undertaken in 1997 in the US for the Organization for Economic Cooperation and Development (OECD), wherein they identified two other models/theories that has an influence on corporate governance, that is, the finance model and the political model. The political model recognises that all allocation of corporate power, privileges and profits between owners, managers and other stakeholders is determined by how governments favour their various constituencies.<sup>87</sup> According to Hawley & Williams the political model of corporate governance has had immense influence on corporate governance developments in the last five years to seven years. They say that firms have also been influential in moulding the US political/legal/regulatory system over the last few centuries.<sup>88</sup>

In other words, the shareholders are the best suited to guide and discipline managers in the conduct of their powers and duties. Moreover the operation of corporations would be well-run as “both the managers and the non-executives are fully accountable to shareholders for what they do in running the corporation's

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<sup>84</sup> Corp Admin 'Shareholder & Stakeholder Corporate Governance' <http://www.corplaw.i.e/blog> (accessed 12 May 2015)

<sup>85</sup> Leighton D S R & Thain DH *Making Boards Work* (1997)23

<sup>86</sup> Dodd E M 'For Whom are Corporate Managers Trustees?' (1932) 45 *Harvard LR* 1145

<sup>87</sup> Hawley J & Williams A *Corporate Governance : Its scope , concerns & theories* (1996)29

<sup>88</sup> Miller A.S. 'The Supreme Court and American Capitalism,' (1968)31 *Journal of Politics* 576

business. The shareholders absolutely have the rights to intervene the business operation as well as other lawful rights which are not bestowed on stakeholders if the managers or directors breach their duties. Accordingly, a shareholder can bring derivative actions against the managers and directors.

South Africa's principal corporate governance report aspires to an inclusive approach to corporate governance, in which companies are clearly advised to consider the interests of a variety of stakeholders. The purpose of the corporation should be defined in the broader sense than the mere maximisation of shareholder welfare.<sup>89</sup> Hillman and Keim describe the stakeholder theory from a strongly instrumental view in testing relationships among shareholder value creation, stakeholder management, and the corporation's participation in social matters. Building better relations with primary stakeholders like employees, customers, suppliers, and communities could lead to increased shareholder wealth by helping firms develop intangible, valuable assets which can be sources of competitive advantage and is what Hillman and Keim advocates.<sup>90</sup> The said theory warrants that the design of the institutions should make managers internalise all stakeholder's welfare. These stakeholders should include employees, suppliers and customers. The essence of the theory is that the outcome may not only depend on the choices made by one person, but also on the strategies selected by other participating parties.<sup>91</sup> Ethical treatment of stakeholders will benefit the company 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.

## 2.5 Structure and principles of corporate governance

Governance is concerned with the process, systems, practices and procedures, formal and informal rules that govern institutions, the manner in which these rules and regulations are applied and followed, the relationships that these rules and regulations determine or create, and the nature of those relationships.<sup>92</sup> In analysing

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<sup>89</sup> Jensen M. C 'Value maximization, stakeholder theory, and the corporate objective function' (2002) 12(2) *Business Ethics Quarterly* 235.

<sup>90</sup> Hillman A. J. & Keim G. D. 'Shareholder value, stakeholder management, and social issues: what's the bottom line?' 22(2) (2001) 22(2) *Strategic Management Journal* 125-139

<sup>91</sup> Peterson, D. K. 'The relationship between perceptions of corporate citizenship and organizational commitment.' (2004) 43(3) *Journal of Business and Society* 269.

<sup>92</sup> Williamson, O. E. Corporate Governance. (1984) 93 *Yale Law Journal* 1197



a corporate governance system, one must understand the environment in which a company operates; the country's legal framework; the local culture, history and organisation of society; and the roles of the capital market and other active market forces.<sup>93</sup> It is risky to classify governance systems into bad and good, developed and undeveloped, mature and immature because organisations in various countries operate in different environments with different economic traditions and cultures, so there can be no one solution to fit all.<sup>94</sup>

Good corporate governance is founded upon the following principles:

- a. Shareholder recognition: Good corporate governance seeks to make sure that all shareholders get a voice at general meetings and are allowed to participate. A shareholder with a controlling interest is able to influence decisions of the company in controlling the composition of the board of directors.

Good corporate governance seeks to make sure that all shareholders get a voice at general meetings and are allowed to participate. Shareholders of corporations should jointly and severally protect, preserve and actively exercise the supreme authority of the corporation in general meetings.<sup>95</sup> They have a duty, jointly and severally to exercise that supreme authority of the corporation.

- b. Stakeholder interests: Stakeholders are groups and individuals who can affect or be affected by the organisations' purpose.<sup>96</sup> Stakeholders are also defined as individuals and constituencies that contribute either voluntary or involuntary, to its wealth-creating capacity and activities, and who are therefore its potential beneficiaries or risk bearers.<sup>97</sup> There are different stakeholder groups in a company who happen to have either direct or indirect interest in the company.<sup>98</sup>

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<sup>93</sup>Williamson, O. E. 'Corporate Governance'. (1984). 93*Yale Law Journal* 1197

<sup>94</sup> Dodija D *Emergence of Corporate Contract Set, Governance and Accountability* (2008) 4

<sup>95</sup> Colley J. L., Doyle J. L., Logan, G. W and Stettinius W. *What is corporate governance?*(2005)8

<sup>96</sup> Freeman R E *Strategic Management , a Stakeholder Approach* (1984) 5

<sup>97</sup> Post J E, Preston L E and Sachs S 'Managing the Extended Enterprise: The New Stakeholder View' (2002) *California Management Review* 7

<sup>98</sup> Post J E, Preston L E and Sachs S 2002 8

The balance of power between different stakeholder groups and the way in which power is exercised are key in corporate governance.<sup>99</sup>The success of a company depends on how the company handles the interest of its non-shareholder parties. Taking the time to address non-shareholder interests can help the company to establish a positive relationship with the community and whoever has a potential to influence the growth of the company.

- c. Board responsibilities: must be clearly outlined to majority shareholders. All board members must be thoroughly cultured on their strategic role, purpose, mission and vision of the company. Over and above giving strategic direction to the company, the board must delegate executive powers to the managing directors or chief executive officer. Managing directors or the chief executive officer's primary responsibility is to safeguard and protect the interest of the shareholders.

The common law imposes both a fiduciary duty and a duty of care and skill on directors. The 2007 South African Companies Bill (the '2007 Bill') initially proposed to codify directors' duties, and now the 2008 Act partially codifies both the fiduciary duties and the duty of care and skill.<sup>100</sup> The fiduciary duties that directors owe their company require that they act in good faith and for the benefit of the company.<sup>101</sup> These duties are based on the 'general principle that a person standing in a fiduciary relationship to another commits a breach of trust if he acts for his own benefit or to the prejudice of the other'.<sup>102</sup>

- d. Ethical behavior violations in favor of higher profits can cause massive civil and legal problems. A code of conduct regarding ethical decisions should be established for all members of the board. With effective corporate governance based on core values of integrity and trust,

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<sup>99</sup> Kneale C *Corporate Governance in South Africa* (2012) 12

<sup>100</sup> Bouwman N 'An Appraisal of the Modification of the Director's Duty of Care and Skill' (2009) 21 *SA Merc LJ* 509.

<sup>101</sup> Bouwman N (2009) 509

<sup>102</sup> Bouwman N (2009) 509



reputational value companies will have competitive advantage in attracting and retaining talent and generating positive reactions in the marketplace, if you have a reputation for ethical behavior in today's marketplace it engenders not only customer loyalty but employee loyalty.<sup>103</sup>

The new realities of corporate governance show that no entity or agent is immune from fraudulent practices and have altered the way companies operate; they have re-defined the baseline for what is considered prudent conduct for businesses and executives.<sup>104</sup> Byrne also noted that in the post-Enron, post-bubble world, the realization that many companies played fast and loose with accounting rules and ethical standards and which allowed performance to be disconnected from meaningful corporate values, is leading to a re-evaluation of corporate goals, values and purpose.<sup>105</sup>

Young and Thyl contends that corporate governance is founded on a system of ethics or the sets of relatively shared values and norms that are expressed and negotiated<sup>106</sup> Whilst Fleming and McNamee states that corporate governance principles are concerned with moral philosophy, values and norms of behaviour that guide a corporation's behaviour within society.<sup>107</sup> In this vein, Rossouw advances the concept of "the governance of ethics" as a concept that captures the manner in which the organization is ethically governed and includes, amongst other things, the development of codes of ethics and rules of conduct, the training of boards of directors and staff with regard to ethics, and the undertaking of ethics audits.<sup>108</sup>

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<sup>103</sup> Arjoon S *Corporate Governance An Ethical Perspective* (2005) 20

<sup>104</sup> Dandino P *Corporate Governance: Something for Everyone* Franchising World, 36 (1) (2004) 41

<sup>105</sup> Byrne H *Mastering Global Corporation Governance* (2002) 11

<sup>106</sup> Young, S. and Thyl, V. (2009) *Anglo-based Governance- Rules versus Flexibility: the Continual Debate Contemporary Issues in International Corporate Governance*, (2009) Chapter 2, 11.

<sup>107</sup> Fleming S & McNamee M 'The ethics of corporate governance in public sector organizations' (2005) 7(1). *Public Management Review*, 137

<sup>108</sup> Rossouw GJ 'The ethics of corporate governance: A (South) African perspective' (2009) Vol. 51 Iss: 1 *International Journal of Law and Management* 10

- e. Business transparency is the key to promoting shareholder trust. Transparency means openness, a willingness by the company to provide clear information to shareholders and other stakeholders.<sup>109</sup> For example, transparency refers to the openness and willingness to disclose financial performance figures which are truthful and accurate.<sup>110</sup>

Transparency and disclosure are essential elements of a robust corporate governance framework as they provide the base for informed decision making by shareholders, stakeholders and potential investors in relation to capital allocation, corporate transactions and financial performance monitoring.<sup>111</sup>

- f. Efficiency and effectiveness: Effective corporate governance promotes the efficient use of resources both within the company and the larger economy. As such when corporate governance systems are effective, debt and equity capital would flow to those corporations capable of investing it in the most efficient manner for the production of goods and services most in demand, and with the highest rate of return.<sup>112</sup> In this regard, effective governance helps protect and grow scarce resources, and helps ensure that societal needs are met.<sup>113</sup> In addition, effective governance should make it more likely that those managers who do not put scarce resources to efficient use, or who are incompetent or at the extreme corrupt, are replaced.<sup>114</sup>

- g. Accountability: It also means that all role players must be held accountable for their actions or omissions. This principle provides for the support of the system's corporate engagement and governance initiatives to achieve long term sustainable risk adjusted investment returns.<sup>115</sup> The directors should be accountable to shareowners and

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<sup>109</sup> Trust P 'The Core Principles of Good Corporate Governance' <http://www.pearse-trust.i.e/blog> ( accessed 12 May 2015)

<sup>110</sup> Trust P 'The Core Principles of Good Corporate Governance' <http://www.pearse-trust.i.e/blog> ( accessed 12 May 2015)

<sup>111</sup> Fung B 'The Demand and Need for Transparency and Disclosure in Corporate Governance' (2014) 73 *Universal Journal Of Management* 73-80

<sup>112</sup> Holly J. G & Marsha E. S *Corporate Governance: What It Is And Why It Matters* ( 1999)2

<sup>113</sup> Holly J. G & Marsha E. S *Corporate Governance: What It Is And Why It Matters* ( 1999)2

<sup>114</sup> Holly J. G & Marsha E. S *Corporate Governance: What It Is And Why It Matters* ( 1999)3

<sup>115</sup> Calpers 'Global principles of Accountability corporate – governance' <http://www.calpers-governance> (accessed 13 August 2015)

management accountable to directors.<sup>116</sup> To ensure this accountability, directors must be accessible to shareowner inquiry concerning their key decisions affecting the company's strategic direction.<sup>117</sup>

A consistent and coherent legal and regulatory framework is also key aspect of ensuring accountability of both the State acting as owner and the SOEs themselves, in that it establishes a clear division of responsibilities, objectives and expectations. An ownership policy, specifying the purpose of state ownership and the expectations of the State should be a prerequisite to providing individual SOEs with clear objectives, both commercial and non-commercial, and so that the government, acting as owner, is guided by a consistent and coherent approach.<sup>118</sup>

- h. Sustainability: is about promoting ethical responsibility, sound corporate governance practice, providing safe working environment in which the health of employees is protected, minimising adverse environmental impacts and providing opportunities for social and economic development within the communities that the company operates.<sup>119</sup> This principle integrates the balance of three pillars which are economic growth, social responsibility and the responsibility for the environment. Profitability and growth create jobs and wealth and on the other side companies will continue to provide products and services that people will need.

## 2.6 Current regulatory framework on corporate governance in South Africa

- a. The growth of corporate governance in most major economies of the world has seen the establishment of various legal and regulatory regimes which are aimed at controlling, supervising and managing how corporations are governed. In South Africa the main regulation that concern corporate governance is the Companies Act, 2008 (Act 71 of 2008).

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<sup>116</sup> Calpers 'Global principles of Accountability corporate – governance' <http://www.calpers-governance> (accessed 13 August 2015)

<sup>117</sup> Calpers 'Global principles of Accountability corporate – governance' <http://www.calpers-governance> (accessed 13 August 2015)

<sup>118</sup> OECD State-owned Enterprises in Southern Africa *A Stocktaking of Reforms and Challenges* (2014) 4

<sup>119</sup> Kocmanova *A Corporate governance and sustainability* (2012) 545

The reforms that were also introduced in South Africa includes stringent rules and requirements by the Johannesburg Stock Exchange (JSE) as the self-regulators of the equity market; innovation in disclosure and transparency which is to solve conflicts of interest among the stakeholders of corporate governance.<sup>120</sup>

b. Common Law

The South African common law relating to companies arose primarily as a result of judicial interpretation of the Act and the general body of company law, and draws extensively on English legal precedent.<sup>121</sup> According to it a director is subjected to the fiduciary duties to act in good faith to the benefit of the company as a whole and to avoid a situation where the director's personal interest conflicts with that of the company.

c. Companies Act, 2008 (Act 71 of 2008)

The Companies Act and Regulations plays a key role as the first legislation that included the corporate governance framework in its statute book. The Act prescribes a number of governance requirements that seeks to ensure that South African companies are in tune with the changing business trends and development. Furthermore, the Act also brings about the importance of the corporate environment in South Africa to keep pace with international developments and trends to ensure that new business initiatives and company expansions can take place in South Africa. The companies Act directly provides clear a framework for the empowerment of stakeholders and includes a directive that companies operate to enhance not only shareholder profits but also social welfare.<sup>122</sup>

The Act as compared to the previous company legislation in South Africa introduces the concept of the company as a means of achieving economic and social benefits. Stakeholder protection is addressed in section 76(3)(b). Furthermore section 72(4) provides for the establishment of a social and ethics

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<sup>120</sup> Malherbe, S. and Segal, N. *Corporate Governance in South Africa* (2001) 5

<sup>121</sup> Naidoo R *An essential guide for South African companies* (2002) 10

<sup>122</sup> Mongalo H T *Modern Company Law for a Competitive South African Economy* (2010) 20

committee. Chapter 2, Part C deals with the general transparency and accountability requirements. Enhanced requirements are furthermore listed in chapter 3. This is, however, only applicable to certain companies.

The specific position of directors, prescribed officers, the company secretary, auditors and audit committees are also provide for by the Act. The duties of directors are partially codified in section 75 and 76. These duties include the duty to act with reasonable care, skills and diligence and the duty to disclose personal financial interests in matters to be considered by the board.

The financial regulatory system in South Africa comprises of three main components that includes, the regulation of financial instruments, regulation of the market in which this instrument is being traded and the regulation of those that participated in the market. Furthermore, regulation of financial institutions is divided between the South Africa Reserve Bank, the Registrar of Banks, and Financial Services Board (FSB).

d. Financial Markets Act, 2012 (Act No. 19 of 2012)

The said Act provides for the regulation of financial markets, licensing and regulating exchanges, central securities depositories, clearing houses and trade repositories. It further regulates and control securities trading, clearing and settlement and the custody and administration of securities. Furthermore it provides for the prohibition of insider trading and other markets abuses. The implementation of the Act was aimed at increasing confidence in financial markets in South Africa so as to promote innovation and investment in South Africa market and companies. The reporting obligation on the other hand has been widened to encouraged transparency and high standards within corporations thereby reducing systemic risk among companies.

e. King Reports

The King Committee on corporate governance was inaugurated in 1992 and the first King Report (King I) on corporate governance was issued in 1994. This

report was tailored toward the UK Cadbury Report of 1992.<sup>123</sup>The King I Report comprises the code of corporate practices and conduct and this was the first corporate governance Code of firms in South Africa. The king I Report served as a reference point for policy makers in the examination and development of legal and regulatory frameworks for corporate governance.<sup>124</sup>

The King 1 Report recommended standards of conduct for boards and directors of listed firms such as financial, non-financial and state-owned companies. In addition the said Report suggested that all stakeholders should be involved in corporate governance practices of firms. It further provided for the main principles on corporate governance practice which covered the composition, role and guidance on the category for board of directors and non-executive directors. The appointments to the board for executive directors and guidance for maximum terms for them, determination and disclosure of directors' remuneration and meetings of board are also covered. Other areas included in the said report are the balance of annual reporting, requirements for effective auditing, and codes of business ethics.<sup>125</sup>

The King II report was issued in March 2002; this report consists of new sections on sustainability, the role of the corporate board and risk management.<sup>126</sup> The focus of the said Report was to show that there is a connection between economic and societal goal. That basically implies that in shaping corporate governance reform in South Africa there is a relationship between economic and societal variables.

In March 2010 the King III Report was published. This Report focuses on the move from a comply or explain approach to a principle based apply or explain approach. The existence of better corporate governance practice in South Africa attracts more investors for strong economic development in the sub-region.<sup>127</sup>This is similar to the comply and explain basis that King II operated on.

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<sup>123</sup> Andreasson S *The Political Economy of Corporate Governance in South Africa* (2007)

<sup>124</sup> Moyo NY *South Africa principles of corporate governance : legal and regulatory restraints on powers and remuneration of executive directors*, (2010) 10

<sup>125</sup> Moyo NY *South Africa principles of corporate governance : legal and regulatory restraints on powers and remuneration of executive directors* (2010)10

<sup>126</sup> Andreasson S *The Political Economy of Corporate Governance in South Africa* (2007)5

<sup>127</sup> Vaughn M and Ryan L V *Corporate Governance: An International Review* (2006) 5

The King III committee found the word apply more appropriate than comply. The King III Report applies to all entities regardless of the manner and form of incorporation or establishment irrespective of whether it is a public, private or non-profit sector.

The King III Report recommended that organisations should have an integrated report in place of annual reports and as separate sustainability reports in according to the Global Reporting Initiative Sustainability Reporting Guideline.<sup>128</sup> In addition, the following are the new principles introduced as part of the corporate governance Code in the King III Report IT governance, business rescue, and fundamental affected transaction in term of director's responsibility during mergers, acquisition and amalgamation. There are statutes which involve companies and directors that are briefly summarised in the King III Report and that includes the Public Finance Management Act and Promotion of Access to Information Act.<sup>129</sup>

King IV report which is scheduled to be published in 2016 will be building on the content of King III. The same subject matter will be covered but consideration will be given to enhance the executive and directors' remuneration, integrated reporting, responsible investing and linkage with the Code for Responsible Investing in South Africa.<sup>130</sup> The evolving role of social and ethics committees, mandated audit firm rotation and information security and protection, tendering and strategic risks group governance, board diversity and combined assurance are amongst other topics that will be addressed in this report.<sup>131</sup>

## 2.7 Conclusion

Throughout history, the corporate form has served as the most appropriate vehicle to raise and marshal substantial resources.<sup>132</sup> Conversely corporate governance is claimed to bring about the strength of the control structure of a business, increasing accountability of management and maximises sustainable wealth creation.

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<sup>128</sup> Price Water House Coopers, 2009

<sup>129</sup> Price Water House Coopers, 2009

<sup>130</sup> Terms of Reference of the Draft Code of Good Corporate Governance King IV

<sup>131</sup> Terms of Reference of the Draft Code of Good Corporate Governance King IV

<sup>132</sup> A D. Chandler, *Organizational Capabilities and the Economic History of the Industrial Enterprise*(1992) 79



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.”<sup>133</sup>*

#### 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

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<sup>133</sup> 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.<sup>134</sup> Merz and McLellan, were commissioned to examine the general question of electricity supply in South Africa.<sup>135</sup> 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.<sup>136</sup> 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.<sup>137</sup> 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.<sup>138</sup>

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.<sup>139</sup> 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

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<sup>134</sup>Eberhard 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'

<sup>135</sup>Eberhard 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'

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

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

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

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

protocol on cooperative governance.<sup>140</sup> 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.<sup>141</sup>

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.<sup>142</sup> 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.<sup>143</sup> 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.<sup>144</sup>

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

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<sup>140</sup>McDonald D (2001) 64

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

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

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

<sup>144</sup> 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.<sup>145</sup>

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.<sup>146</sup>

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.<sup>147</sup> 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.<sup>148</sup>

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

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

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

<sup>148</sup> 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.<sup>149</sup> 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.<sup>150</sup>

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.<sup>151</sup> 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.<sup>152</sup>

In 1950 the government appointed a committee to investigate all aspects of producing oil from coal.<sup>153</sup> 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,

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

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

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

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

<sup>153</sup> 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.<sup>154</sup>

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.<sup>155</sup>

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.<sup>156</sup> 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.<sup>157</sup>

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.<sup>158</sup>

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.

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

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

<sup>156</sup> 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)

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

<sup>158</sup> 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.<sup>159</sup> 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.<sup>160</sup>

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.<sup>161</sup> 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.<sup>162</sup> 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.<sup>163</sup>

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

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<sup>159</sup> Sasol Annual Report 2013

<sup>160</sup> 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

<sup>161</sup> Sasol Annual Report 2013

<sup>162</sup> 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

<sup>163</sup> 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.<sup>164</sup>The 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.<sup>165</sup>

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.<sup>166</sup>

### 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.<sup>167</sup>

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.<sup>168</sup>

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<sup>164</sup> Foskor Annual Report 2013

<sup>165</sup> Foskor Annual report 2013

<sup>166</sup> Foskor Annual report 2013

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

<sup>168</sup> 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.<sup>169</sup>

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.<sup>170</sup> 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

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

<sup>170</sup> 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 following<sup>171</sup>:

- (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,<sup>172</sup> 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,

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<sup>171</sup> Lardy N R *China's Unfinished Economic Revolution* (1998) 24

<sup>172</sup> 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.<sup>173</sup>

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;

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<sup>173</sup> 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.<sup>174</sup>

(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.

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<sup>174</sup> 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.<sup>175</sup>

(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

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<sup>175</sup> 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.<sup>176</sup> 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.

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<sup>176</sup> 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"<sup>177</sup>*

#### 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

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<sup>177</sup> 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.<sup>178</sup>

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.<sup>179</sup>

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.<sup>180</sup>

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.<sup>181</sup> 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.

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

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

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

<sup>181</sup> 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.<sup>182</sup> 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.<sup>183</sup> 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.<sup>184</sup>

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.<sup>185</sup> 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.'<sup>186</sup> He further contends that there is an inappreciative amount of reliance on them in the modern day workplace and

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

<sup>183</sup> McGregor L (2012) para 2

<sup>184</sup> McGregor L (2012) para 1

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

<sup>186</sup> 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.<sup>187</sup>

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.<sup>188</sup> 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.<sup>189</sup> 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.<sup>190</sup>

#### 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.<sup>191</sup> 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

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

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

<sup>189</sup> The Report of the Committee on Financial aspects of Corporate Governance, 1992

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

<sup>191</sup> 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.<sup>192</sup> 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.<sup>193</sup>

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.<sup>194</sup> 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.<sup>195</sup>

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.<sup>196</sup> In addition to regulation, governance practices are also reflected in different factors such as culture, traditional financial options, corporate ownership patterns and legal origins.<sup>197</sup> 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.

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

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

<sup>194</sup> 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

<sup>195</sup> 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

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

<sup>197</sup> 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.<sup>198</sup> 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.<sup>199</sup> 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.<sup>200</sup>

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

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

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

<sup>200</sup> 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).<sup>201</sup> 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.<sup>202</sup> 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.<sup>203</sup> Securities law and investor protection present a fine example of the incomplete law problem.<sup>204</sup> 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.<sup>205</sup> Potential harm comes to investors in an infinite variety of forms.<sup>206</sup> They conclude their argument by saying that 'other means of law-making and law enforcement are required to achieve optimal law enforcement.'<sup>207</sup> They suggest that proactive law enforcement combined with the right to adapt rules flexibly over time can serve as a solution.<sup>208</sup>

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

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<sup>201</sup> 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

<sup>202</sup> 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

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

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

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

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

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

<sup>208</sup> Pistor, K and Chenggang Xu, (2003) 23

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



towards external investors.<sup>210</sup> 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.<sup>211</sup> 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.<sup>212</sup>

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.<sup>213</sup> This leads to increased disclosures about corporate governance, demands for the regulation of systems of corporate governance, and consequentially, enhanced internal control systems.<sup>214</sup> 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.<sup>215</sup>

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.<sup>216</sup>

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

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

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

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

<sup>214</sup> Dalton C M & Dalton D R (2006). 5

<sup>215</sup> Dalton C M & Dalton D R (2006). 5

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

#### 4.4 International Perspective

Since the 17<sup>th</sup> 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.<sup>217</sup>

The essence of corporate governance is concerned with issues of ownership and control of the enterprise.<sup>218</sup> 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.<sup>219</sup> 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.<sup>220</sup> 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.<sup>221</sup> 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

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

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

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

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

<sup>221</sup> 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.<sup>222</sup>

Anglo-American systems were viewed as unfavourable to insider systems because corporate control was exercised by agents with permanent economic ties with the company.<sup>223</sup> 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.<sup>224</sup> It was in the 1980, an era of globalisation, when analysts came to an agreement that agency problems can lead to poor corporate governance.<sup>225</sup> They were of the view that management was effectively shielding itself from accountability.<sup>226</sup> The American model of corporate governance provides a powerful legal right to shareholders to call corporate managers to account.<sup>227</sup>

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'.<sup>228</sup> 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.<sup>229</sup> In undertaking SOE reforms, policy makers face at least three options: changing ownership mainly through privatisation, introducing competition, or managerial and institutional reforms.<sup>230</sup> 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.<sup>231</sup> Greater exposure to competition requires market-oriented reforms that expand the reach of the market economy,

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<sup>222</sup> Arora A (2011) 32(1)

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

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

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

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

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

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

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

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

<sup>231</sup> 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.<sup>232</sup> 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.<sup>233</sup> 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.<sup>234</sup>

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.<sup>235</sup> 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

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

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

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

<sup>235</sup> 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.<sup>236</sup> 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.<sup>237</sup> 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.<sup>238</sup>

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.<sup>239</sup> 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.<sup>240</sup>

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.<sup>241</sup> Ever since, most of New Zealand companies comply with corporate governance regulations even though it is not mandatory to do so.<sup>242</sup> 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.<sup>243</sup>

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

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

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

<sup>239</sup> 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

<sup>240</sup> 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

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

<sup>242</sup> Chiu P & Monin J(2003)123

<sup>243</sup> 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.<sup>244</sup> 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

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<sup>244</sup> 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.<sup>245</sup> 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.<sup>246</sup>

##### 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

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

<sup>246</sup> 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).<sup>247</sup> 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.<sup>248</sup>

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.<sup>249</sup> 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%.<sup>250</sup> 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.<sup>251</sup> 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).<sup>252</sup>

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

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

<sup>249</sup> Arcot S, Bruno V & Grimaud A F (2005) 6

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

<sup>251</sup> Owusu-Ansah, S (2005)15(2) 142

<sup>252</sup> 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.<sup>253</sup> 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.<sup>254</sup> 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.<sup>255</sup> 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.<sup>256</sup> The Code deliberately focused on the working of one-tier boards and on the role of auditors in the United Kingdom.<sup>257</sup>

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

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<sup>253</sup> Arcot S, Bruno V & Grimaud A F (2005) 6

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

<sup>255</sup> 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)

<sup>256</sup> Colton CC (2012) 11

<sup>257</sup> Colton CC (2012) 11

prescribed rigid rules that requires strict adherence could actually be counter-productive and harm good governance.<sup>258</sup> He continues to say that business environment changes so rapidly and the rules are often out of date before the ink dry up.<sup>259</sup> 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.<sup>260</sup>

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.<sup>261</sup> 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.<sup>262</sup>

### 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.<sup>263</sup> 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.<sup>264</sup> 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.<sup>265</sup> In 1974, the SEC began requiring disclosure of the

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

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

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

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

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

<sup>263</sup> Hollister H. T: Shock Therapy<sup>4</sup> for Aktiengesellschaften: Can the Sarbanes-Oxley Certification Requirements Transform German Corporate Culture, 'Practice and Prospects?' ( 2005) 25 *Northwestern Journal of International Law & Business*. 453.

<sup>264</sup> Hollister H. T:(2005) 453.

<sup>265</sup> 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.<sup>266</sup>

The 1980s saw a huge wave of hostile takeovers that threatened the hegemony of U.S. managers.<sup>267</sup> 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.<sup>268</sup> 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.<sup>269</sup> 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.<sup>270</sup>

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.<sup>271</sup> 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

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<sup>266</sup> 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

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

<sup>268</sup> Useem M. (1996) 21

<sup>269</sup> Useem M. (1996) 22.

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

<sup>271</sup> 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.<sup>272</sup>

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.<sup>273</sup> 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.<sup>274</sup> 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.<sup>275</sup>

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.<sup>276</sup> 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

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<sup>272</sup> 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.

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

<sup>274</sup> Ribstein L E (2005) 4

<sup>275</sup> Ribstein L E (2005) 4.

<sup>276</sup> 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.<sup>277</sup>

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.<sup>278</sup> 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.<sup>279</sup> Mandatory law matters because it leads to strong markets and enables private contracting.<sup>280</sup> 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.<sup>281</sup> On this view, mandatory corporate governance is necessary just like rules prohibiting insider trading to protect investors.<sup>282</sup>

#### 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.<sup>283</sup> While a

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

<sup>278</sup> 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

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

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

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

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

<sup>283</sup> 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.<sup>284</sup> 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.<sup>285</sup> 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

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

<sup>285</sup> *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.<sup>286</sup>

#### (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.<sup>287</sup>

#### (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.<sup>288</sup>

#### (d) Corporate Governance In Africa

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

<sup>287</sup> 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).<sup>289</sup>

## 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.<sup>290</sup>

## 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

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<sup>289</sup> OECD *Bank Group Policy on Good Corporate Governance* (1999)5

<sup>290</sup> 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.<sup>291</sup> 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.<sup>292</sup>

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.

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<sup>291</sup>Wolfenden J, one time President of the World Bank

<sup>292</sup>OECD *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."<sup>293</sup>*

### 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

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<sup>293</sup> 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.<sup>294</sup>

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

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<sup>294</sup> 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.<sup>295</sup>
- (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.<sup>296</sup> Standing out prominently among these challenges is the potential for controlling shareholder dominance

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

<sup>296</sup> 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.<sup>297</sup> 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.

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<sup>297</sup> 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.<sup>298</sup>

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<sup>298</sup> 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.

*Total words composition of 30 558.*



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