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THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE OF COMPANIES LISTED ON THE JSE LTD

by

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MINOR DISSERTATION

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in

FINANCE

in the

FACULTY OF ECONOMIC AND FINANCIAL SERVICES

at the

UNIVERSITY OF JOHANNESBURG

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Abstract

This study explores the relationship between corporate governance and company financial performance within a South Africa context. The importance of governance globally has been stressed by corporate collapses that have occurred in the past 30 years. South Africa presents an intriguing case from which to investigate this as it is an international pioneer of governance standards in the form of the King Code and is an emerging economy categorised by its high dependence on capital flows, flagging economy and growing socio-political tensions. By utilising a panel data analysis, a sample of 30 South African companies listed on the Johannesburg Stock Exchange (JSE) was selected. A governance index was constructed based on the provisions of King III and regressed against two financial performance measures. The findings indicated that there was no relationship between the return on assets ratio and the governance index. However, there was a statistically significant and positive relationship between Tobin's Q and the index. The findings thus suggest that investors are willing to pay a premium for companies that are better governed. This has important implications for companies and policymakers in South Africa. The significance of this relationship implies that if companies can adhere to the best standards of corporate governance, then this will strengthen the confidence of both local and international investors in the country's institutions and financial markets, which will have a broader positive impact on South Africa's long-term competitiveness. Furthermore, if policymakers can implement effective standards, it may also have a stabilising effect on the economy as foreign entities look to invest their money in well-governed corporations which will increase capital inflows into the country. Further research should develop a model that facilitates the comparison of findings between various other developing or developed countries.

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Key words

Corporate governance, profitability, company performance, corporate governance index, panel data regression, Johannesburg Stock Exchange (JSE Ltd)

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CHAPTER 1

INTRODUCTION AND BACKGROUND TO THE STUDY

1.1 INTRODUCTION

1.1.1 The role of corporate governance in recent years

The discipline of corporate governance has become ever more critical to economies given the enormous global implications of corporate mismanagement. Testament to this statement is the fact that in 2009, the International Monetary Fund (IMF) calculated that the entire cost of the Global Financial Crisis was $11.9 trillion, which is equivalent to one-fifth of global economic output on an annual basis (Sun, Stewart & Pollard, 2012: 2).

In modern society corporate governance has become ubiquitous. It is a fundamental topic that is discussed reverently within corporate boardrooms, academic meetings and policy factions around the world (Claessens, 2006: 91). Its pervasiveness is due to the increase of structural challenges within corporate companies that can take the form of fraud, accounting scandals, excessive director remuneration and various organisational failures that are prevalent within the global economy (Sun et al., 2012: 1).

The increased proliferation of these incidences and how they have impacted broader society has thrust corporate governance into the spotlight and has influenced growing economic development and policy issues in many countries. These occurrences are compounded by the following factors:

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- Spread of capitalism and privatisation
- Corporate growth
- Globalisation and deregulation
- The Global Financial Crisis

Each of these factors will subsequently be discussed in detail in order to emphasise the importance of corporate governance and the role it plays in the global financial economy.

1.1.2 Capitalism and privatisation

The spread of privatisation has led to the increased impetus placed on governance concerns that were formerly only governmental issues. Market-based economic systems have become

more favourable substitutes for control-based economic systems. This change is most prevalent in countries such as Russia and China.

Companies are going public in order to source capital, while governments all over the globe are relinquishing their ownership interests to the private sector (Gregory, 2000: 3).

1.1.3 Corporate growth

Corporations have demonstrated their ability to be efficient facilitators of economic activity. The result of this has led to the exponential growth of large multinational conglomerates that have a global reach, and economical and political influence that supersedes the power of governments (Gregory, 2000: 3). The mobilisation of capital has become further removed from the principal owner as companies have expanded in size and the function of financial intermediaries has become more vital (Claessens, 2006: 95). This devolution of investment requires that there are efficient corporate governance regulations in place.

1.1.4 Globalisation and deregulation

The rise of globalisation has been facilitated by significant technological advances and the removal of trade and investment barriers. Deregulation and distribution technologies have restructured the national and international financial environment. Traditional institutional corporate governance policies need to keep pace in order to remain relevant and effective. Organisations are not only expected to compete with other local entities, but also with corporations from around the world (Gugler, Mueller & Yurtoglu, 2004: 129). Corporate governance has traditionally been limited to a domestic outlook and issues have been resolved within a local setting (Adeyeye, 2012: 172). However, with the increasing integration of the world's economies, the strength of global competition has had to be addressed.

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Consequently, product life cycles have decreased, profit margins are shrinking and companies need to continuously innovate in order to survive. Capital markets are also providing companies with the opportunity to attain the lowest costs of funding from across the globe. This has created a truly international platform for the financial services industry. The result of this intense competition has given rise to a debate about the competitiveness of countries' financial institutions (Porter, 1990).

1.1.5 The Global Financial Crisis

A concerted enhancement of corporate governance codes, principles and mechanisms has come into effect subsequent to the Global Financial Crisis. This is due to the origins of the present crisis stemming from governance failures and weaknesses in the financial industry. The breakdown of the US real-estate sector and the consequent off-loading of subprime

mortgage-backed securities resulted in a credit crisis. The reckless use of complicated debt instruments such as collaterised debt obligations and the enforcement of a culture that rewarded senior banking officials with exorbitant salaries and bonuses, fuelled the problem (van Essen, Engelen & Carney, 2013: 202). The increasing integration of economies around the world turned the credit crisis into a global epidemic.

There are several governance issues that can be identified. The regulatory collapse in governing financial companies before the crisis was influenced by extensive deregulation in the finance industry. Boards of directors failed to effectively monitor executives and were ill-equipped to assess the risks they undertook (Muller-Kahle & Lewellyn, 2011). Other regulatory failures included the significant increase in the gearing levels that financial institutions were allowed to accept, inadequate capital and uncontrolled risks borne, and the transference of a large amount of assets and liabilities from the balance sheet to structured investment vehicles (SPVs) (Sun et al., 2012: 10). The recent crisis has revealed that capital market interconnectedness is both beneficial and destructive. Although market liquidity and efficiency has improved, increasing integration could also lead to larger and more frequent asset bubbles if corporate governance reforms are not implemented (Ghai, Tarnowski & Tetrault, 2011: 6).

The Financial Crisis represents a classic case study of corporations that followed dubious governance systems and consequently went bankrupt or suffered extreme losses. There is irrefutable evidence of the fundamental importance of having a good corporate governance structure. Inherent in this is the continuous challenge that regulators face in terms of implementing effective governance standards that evolve and keep pace with the rapidly changing financial environment.

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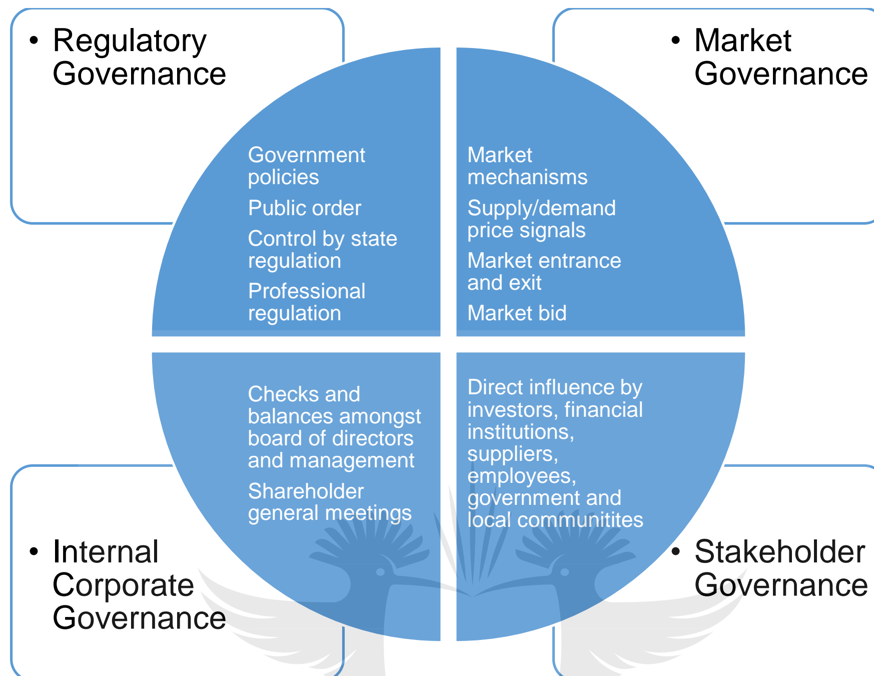
According to Claessens (2006:103) better corporate governance adds value in the following ways:

- Contributes to more efficient management as asset allocation is greatly improved
- More effective labour policies are embraced
- Endorses higher firm valuations
- Generates better rates and higher returns on equity
- Ensures greater profits and sales growth

Corporate governance constitutes three pillars of legal, cultural and institutional organisational structures. The Figure 1.1 illustrates the properties inherent within these structures.

FIGURE 1.1: Overview of Corporate Governance



Source: *Sun et al. (2012: 8)*

1.2 THE CHANGING PERSPECTIVE OF HOW WE DO BUSINESS

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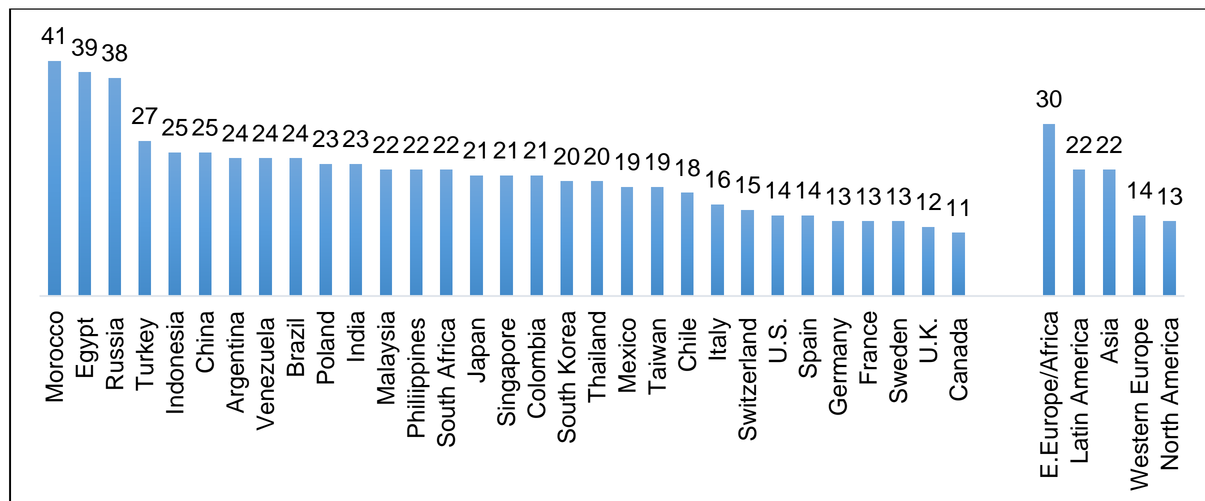
According to the Global Investor opinion survey (Mckinsey & Company, 2002) nearly 80% of the 200 institutional investors surveyed from 31 countries across the globe would pay a premium for a well-governed company. Figure 1.2 depicts the various premiums by market, ranging from 22% for a company in South Africa to almost 40% for a company in Egypt. These results imply that good corporate governance serves as the foundation that secures investor certainty, enables entry to capital markets, promotes economic growth and strengthens countries' financial systems. Corporate governance's increasing impetus will effect a country's financial stability and its potential for expansion.

FIGURE 1.2: Average premiums (%) investors would pay for a well-governed company by country



Source: McKinsey and Company (2002)

Gregory (2000: 2) observed that 50% of European investors and 61% of US investors decline share purchases or at worst reduced investments in corporations due to observed poor governance practices.

Waweru (2014: 463) states that raising funds, attracting investment and strengthening a company's basis for future success can all be achieved through adopting a definite and effective corporate governance framework. A good corporate governance structure can make companies less vulnerable to future corporate collapses. The following extract encompasses the importance of corporate governance in today's modern economies:

> In an increasingly integrated world characterised by highly mobile capital, investors' expectations for more responsive corporate governance practices are something that governments and companies cannot afford to ignore (Waweru, 2014: 463).

This is not simply an issue relevant to foreign investors. Strengthening the confidence of domestic investors in a country's own corporations and stock markets matters greatly to the longterm competitiveness of companies and to the overall health and vitality of national economies' (OECD, 1999: 6).

1.3 THE ROLE OF CORPORATE GOVERNANCE IN SOUTH AFRICA

Corporate governance is an important concern for developing countries that are looking to attract foreign investors and capital, as they are competing with the likes of developed countries where market participants are not as worried about the quality of corporate

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governance policies (Andreasson, 2009: 648). Foreign direct investment is imperative to the growth and variability of a developing market economy (Vaughn & Ryan, 2006: 509). Economic instability and institutional weakness are characteristics that currently limit the level of foreign direct investment into Africa.

South Africa is an intriguing case study as it encompasses a dual economy that has characteristics of both an emerging and developed country. It is one of the leading and most advanced economies in Africa (Vaughn & Ryan, 2006: 504). South Africa was ranked 3rd for financial market development and 35th for business sophistication by the World Economic Forum Global Competitiveness Survey (2014). One reason for the country's astounding success is its development in the area of corporate governance. South African corporations have been challenged by both constitutional and labour legislation to adhere to corporate governance reforms that are subsequently encouraging an influx of foreign investment into the country. The country's financial infrastructure rivals that of any developed country and as such is the reason a majority of private equity held in South Africa, is maintained by international institutions. This is an important vote of confidence in the country's capital markets and financial system (Andreasson, 2009: 653). According to Andreasson (2009: 656), corporate governance has enhanced the strength and legitimacy of South Africa's economy in the face of an unpredictable sociopolitical environment.

South Africa founded the publication of corporate governance guidelines and codes of best practice in 1994 which was completed by the King Committee. The code was not implemented as a result of any major crisis, but was rather developed in order to enhance the competitiveness of the South African corporate sector following South Africa's conversion to a wholly-formed democracy after the end of apartheid. Subsequent adjusted and improved King reports were released in 2002 and 2009 respectively (Waweru, 2014: 459). They are evidence of how a developing economy can develop provisions that align good governance with corporate policy, which can simultaneously address corporate social responsibility and broad-based economic development standards (Andreasson, 2009: 655). Although South African companies have a solid corporate governance underpinning, there have been several corporate collapses, namely Fidentia, JCI-Randgold, Masterbond, Macmed, Regal Treasury and most recently African Bank, Telkom and PPC (Waweru, 2014: 458).

Despite these corporate failures, South Africa remains a prominent force within the domain of corporate governance as it is regarded as one of the best self-regulated country's around the world today (King, 2013). This is indicative of the increasing impetus that is being placed on local corporations to adhere to the highest standards of governance. In this way, South African

companies embrace and implement effective governance mechanisms that are sustainable and complement core profit generating objectives.

1.4 RESEARCH PROBLEM STATEMENT

The global financial crisis and latest corporate failures which have transpired globally, have given credence to the importance of a good corporate governance management policy. Corporate governance has altered the dynamics of how companies run and manage their businesses.

South Africa is unique because it was the first emerging economy to pioneer the publication of corporate governance guidelines in 1994. As Africa's second biggest economy, it has substantial influence on the continent. The country offers first-world financial and regulatory structures that have given rise to a deep equity culture which is the basis for a number of multinationals (Malherbe & Segal, 2001). This would prove to be especially beneficial within a South African context as the country's corporate governance system is highly regarded by both international and local regulators, investors and companies.

It is argued that better insights into the antecedents of effective corporate governance mechanisms will be instrumental in determining how South African companies can efficiently improve performance by implementing effective governance structures.

1.4.1 Research question

Based on the extant literature, the relationship between corporate governance and profitability is not thoroughly understood within a South African context. Therefore, it is anticipated that by obtaining an improved understanding of South African listed companies' corporate governance compliance in relation to specific firm performance characteristics, it will be possible to assess and analyse the significance of the relationship between corporate governance and company performance. Based on the lack of academic research performed on the relationship between corporate governance and company performance, this study proposes to investigate the following research question: Is there a significant relationship between corporate governance and company performance?

This study will make use of a corporate governance index to determine its effect on corporate performance within South African companies listed on the JSE. In order to address this question, the following hypotheses will be tested:

H_o: There is no significant relationship between the corporate governance index and company performance.

H_a: There is a significant relationship between the corporate governance index and company performance.

1.5 RESEARCH OBJECTIVES

The specific research objectives emanating from the purpose of the study, within a South African context, were:

- To empirically identify if there is a relationship between company performance and corporate governance.
- To review the literature to interpret and reflect on the key characteristics of corporate governance within a global and South African context.
- To evaluate the role corporate governance performs in listed South African companies and its impact on company performance.
- To determine the unique properties of corporate governance applicable to South Africa.
- To develop a corporate governance index that is representative of South Africa's unique governance regulations, but that can also be comparative.
- To construct an index that is based on the provisions of King III which is in line with previous research (Ntim, 2013).
- To identify key corporate governance mechanisms that will be incorporated into the corporate governance index.
- To measure the relative importance of key corporate governance mechanisms against company performance variables.
- To regress the company performance variables against the corporate governance index.
- To control specific variables such as leverage and growth which will ensure the reliability and soundness of the empirical results.
- To explore the implications of the relationship between corporate governance and company performance.

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1.5.1 Contribution of the study

Although there has been a plethora of papers published in the field of business ethics in South Africa (Andreasson, 2009; Rossouw, 2009; Vaughn & Ryan, 2006; West, 2006; Rossouw, van de Watt & Malan, 2002) the influence of corporate governance on firm performance has yet to be explored on an empirical basis (Bhana, 2010: 1).

The majority of previous research that explored the relationship between corporate governance and firm performance asserts that there is a positive association (Ntim & Kofi, 2011; Klapper & Love, 2002; Gompers, Ishii & Metrick, 2003). However there are alternative studies that have reported a negative association (Hutchinson, 2002; Bathala & Rao, 1995) or have not found any significant relationship (Park & Shin, 2004; Singh & Davidson, 2003). A consensus has yet to be reached.

The majority of these studies are concentrated in first-world countries such as Europe and the USA which have comparatively similar institutional landscapes (Chen, Chung, Hsu, & Wu, 2010; Bebchuk, Cohen, & Ferrel, 2009; Bauer, Gunster & Otten, 2003; Gompers et al., 2003). They do not take into account the contextual facets of corporate governance mechanisms that vary from country to country (Waweru, 2014: 457).

Prior research is also limited by the fact that it only focuses on certain variables of corporate governance in isolation. Significant among these variables are:

- Takeover defences (Gompers et al., 2003)
- Executive compensation (Loderer & Martin, 1997)
- Block holdings (Demsetz & Villalonga, 2001)
- Board size (Yermack, 1996)
- Board composition (Bhagat & Black, 2001).

If various other corporate governance mechanisms exist and are not taken into account, then this may result in missing variables bias and spurious correlations (Beiner, Drobetz, Schmid & Zimmermann, 2006: 252). Previous papers have not sufficiently addressed the problem of endogeneity, which represents a methodological weakness of these studies (Gompers et al., 2003). This indicates that their findings can only be inferred as partial correlations without intimation of causality.

Therefore this study will be informative and insightful for several reasons, namely:

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- It will present current empirical evidence that will give local entities the opportunity to introduce corporate governance reforms that will contribute to performance maximising objectives.
- The empirical results will reveal the level of corporate governance standards upheld by South African conglomerates which will reassure international investors.
- The unique characteristics inherent within the South African governance framework will be investigated. This will be advantageous for national companies looking to improve their governance standards. In addition it will be illustrative of the dynamics that mostly contribute to improved performance.
- New opportunities in the domain of corporate governance will be identified. This may help companies achieve better performance results.

1.6 OUTLINE OF RESEARCH METHODOLOGY AND DESIGN

Target population

The target population consists of all companies listed on the All Share Index. The FTSE/JSE All Share Index was chosen as the target population as it represents 99% of the full market capital value of all ordinary securities on the main board of the JSE (JSE, 2014).

Sample

A sample consisting of 30 listed companies on the JSE will be used to collect data. These companies represent over 85% of the JSE market capitalisation as of the 31st December 2014. The companies selected represent the largest companies in market value on the JSE. As such, they represent a wide spectrum of stakeholders' interests and shareholders' wealth in South Africa. The sample size is considered adequate to produce reliable results.

Sampling method

Non-probability convenience sampling was used as the sampling method. Convenience sampling was deemed to be the most suitable method for this particular study as a specific section of the target population was chosen, namely 30 companies listed within the FTSE/JSE All Share Index (Saunders, Lewis & Thornhill, 2012: 594; Leedy & Ormrod, 2013: 206).

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Data collection

Quantitative data was collected for 30 companies listed on the FTSE/JSE All Share Index for the period 2009-2013. The data was collected from the annual reports of the companies selected. The annual reports were obtained from Standard Bank's Online Share Trading website.

Secondary data analysis

The use of a secondary data analysis strategy allows for the development of a structured corporate governance index which involves the aggregation of 10 corporate governance provisions contained in King III. Secondary data analysis provides the opportunity to obtain standardised primary quantitative data which can be readily compared and analysed using descriptive and inferential statistics (Saunders et al., 2012: 134; Mouton, 2001: 153).

Research Instrument

A simple binary coding scheme was adopted in order to construct the corporate governance index which is utilised based on previous research (Ntim & Kofi, 2011; Gompers et al., 2003; Bauer et al., 2004). The index is constructed by awarding a value of '1' for each of the 10 governance provisions of King III that are disclosed in the annual report, or '0' if otherwise. A company's total score within a specific year can fluctuate between 0 (0%) and 10 (100%) with better governed firms receiving higher scores and larger index levels.

Data analysis

To measure the potential effect of corporate governance on company performance a panel data analysis was adopted. A panel data set tracks a specific sample of data points over time and as such generates several observations on each data point included in the sample (Hsiao, 2003: 1). Panel data analysis has several advantages that are applicable to ensuring reliable empirical results for the study. According to Baltagi (2009: 6), panel data:

- Controls for individual heterogeneity
- Provides useful data
- Ensures there is less collinearity among variables as opposed to pure time-series or cross-sectional studies
- Allows for more degrees of freedom and efficiency

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Ethical procedures

A code of ethics was developed to ensure that the highest ethical standards were upheld by the researcher. Table 1.1 highlights these standards.

TABLE 1.1: Ethical principles

ETHICAL PRINCIPLE	RATIONALE FOR IMPLEMENTATION OF PRINCIPLE
Integrity of the researcher	The quality of the research is dependent upon the integrity of the researcher. This entails being honest and accurate and avoiding misrepresentation of data and findings.
Ensuring the reliability of the analysis and reporting of findings is accurate.	The collection of the data should be honest and should not be made up or falsified. The reporting of findings should be presented accurately regardless of whether they fulfil the expected outcomes.
Maintaning objectivity	Researchers should strive to uphold objectivity in the treatment of findings and results. Researchers should clearly communicate all research limitations.

Source: *Saunders et al. (2011: 231)*

1.7 DELIMITATIONS AND ASSUMPTIONS

In order to make a justifiable contribution to the area of investigation, it is necessary to demarcate parameters to meet the obligations of the study. Therefore the following delimitations have been applied to this study:

- This study will be limited to firms within South Africa. The incorporation of other countries into the study is beyond the scope of this research paper.
- This study will be limited to companies listed on the JSE. This public disclosure will facilitate the gathering of data used in constructing the corporate governance index.
- This study focuses on 30 companies within the JSE/FTSE All Share Index. This was considered an adequate sample size to generate reliable results within the given time frame.
- The development of a corporate governance index is subjective as the researcher decides on the provisions incorporated within the index.

This study excludes:

- Companies that are not listed on the JSE. Privately held companies and government controlled institutions are not considered.
- Companies that do not adhere to King III. The principles of King III are voluntary based, and as such compliance is not compulsory.

1.8 DEFINITION OF KEY TERMS

Table 1.2 outlines definitions of some of the key terms as sources from the literature or as formulated for the purpose of the current study.

TABLE 1.2: Definitions of key terms

KEY TERMS	DEFINITION
Corporate Governance	The collection of control mechanisms that an organisation adopts to prevent or dissuade potentially self-interested managers from engaging in activities detrimental to the welfare of shareholders and stakeholders.
Shareholder	The owner of one or more shares of stock in a company.
Stakeholder	Any party that has an interest in an enterprise or project. The primary stakeholders in a typical company include investors, employees, customers and suppliers.
JSE	The Johannesburg Stock Exchange.
King Code	The King Report is a code of corporate governance practice issued by the King committee that companies listed on the JSE are required to adhere to.
Corporate	Formed into an association and endowed by law with the rights and liabilities of an individual.
Independent Non-Executive Director	An individual who does not have a direct or indirect interest in the company and who does not receive remuneration contingent upon the performance of the company.
Chairman	A non-executive independent director who chairs the board of directors.

Source: *Conceptualised from West (2006), Larcker and Tayan (2011), Institute of Directors (2009)*

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1.9 DEMARCATION OF CHAPTERS

This minor dissertation is presented in five chapters. These chapters are reviewed within the Table 1.3.

TABLE 1.3: Review of chapters

SECTION	CONTENT
CHAPTER 1	**Introduction** • Contextualises the research problem by introducing the background and development of corporate governance • Presents the research question • Summarises the minor dissertation • States the research objectives, the research methodology applied to investigate these targets and the intended contribution of the study.
CHAPTER 2	**Literature Review** • Analyses and interprets the advances and shortcomings of current literature • Identifies a gap in previous research
CHAPTER 3	**Research Methodology** • Describes the research methodology deployed for the empirical research component of the study • Identifies the research design adopted • Discusses the reliability and validity provisions considered to ensure reliable results • Stipulates ethics that researcher must adhere to
CHAPTER 4	**Empirical Analysis and Interpretation of Results** • Presents empirical evidence generated from the panel data analysis • Provides commentary on the descriptive statistics obtained • Reports on the results from the empirical research
CHAPTER 5	**Conclusion** • Presents conclusions and recommendations

Source: *Researcher's own construct*

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CHAPTER 2

LITERATURE REVIEW

2.1 INTRODUCTION

The aim of the literature review is to constructively and critically analyse relevant research to highlight research possibilities that have been overlooked implicitly in research to date, and to place research findings within a wider body of knowledge (Saunders et al., 2012: 78). Critically reviewing the literature, provides the foundation to address the research question and fulfil the research objectives. The research question will investigate if there is a significant relationship between company performance and corporate governance. This association is evaluated by developing a corporate governance index that is representative of South Africa's unique governance regulations. The review demonstrates a thorough critique of, and provides insight into relevant previous research and the trends that have emerged.

The literature review comprises five sections which are depicted in Figure 2.1. The organisation of literature follows a thematic structure whereby the discussion is analysed in sections that represent categories and conceptual subjects.

FIGURE 2.1: Proposed layout of literature review

Source: *Researcher's own construct*

The **first section** attempts to provide a working definition of corporate governance. Many researchers have contributed to the defining of corporate governance and as such there are numerous different descriptions. The lack of any consensus can contribute towards an entirely different analyses of how corporate governance affects corporate performance. A working definition is proffered by chronologically interrogating significant sources that define corporate governance. A single working definition underpins the dialogue about corporate governance and allows the reader to better appreciate the correlation between corporate governance and company performance.

The **second section** presents the theoretical basis of the study, whereby specific shareholder and stakeholder models are critiqued. These models introduce a discussion that is highly debated within recent corporate governance research reports and studies. Furthermore, this section determines and defines the focus and aim of the research problem by assessing theories that are significant to the research basis.

The **third section** evaluates the development of corporate governance whereby necessary background knowledge to the research question and objectives are discussed and boundaries of the study are established. This section introduces an international perspective on corporate governance that scrutinises specific developments within the United Kingdom and United States. These foreign advances underpin the validity of the South African King Reports and constitute an adherence to a benchmark that is both nationally and internationally focused.

The **fourth section** demonstrates the progression of corporate governance regulation throughout South Africa. This section presents an intriguing case study, since South Africa is at the forefront of corporate governance. This is attributable to the establishment of the King Reports. The review of literature contributes to the uniqueness of the study and provides further insight into the standard of corporate governance upheld by South African companies.

The **fifth section** identifies and examines numerous studies that have explored the relationship between corporate governance and firm performance. This will highlight key points and trends and present them in a logical way that indicates the relationship with the current study. A cohesive and coherent argument on published research findings will acknowledge strengths that will complement the applicable study, whilst also identifying limitations to improve on and increase the validity of results.

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The analysis of these five segments demonstrates the applicability of this study to extant research. The evaluation and synthesis of certain information will position this study within the context of previous research. Furthermore, the literature review should provide evidence that the researcher's knowledge is up to date and that the research is an extension of the existing pool of literature.

2.2 DEFINING CORPORATE GOVERNANCE

The definition of corporate governance has changed over time as a result of the various influences that have affected the discipline throughout its history. Claessens (2006: 93) contends that stipulating a definition is not easily done, as corporate governance can be interpreted and described in various ways. Du Plessis, Hargovan & Bagaric (2010: 3) point out that there is no set definition for corporate governance. The absence of a universal definition can contribute towards an entirely different analysis of how corporate governance effects firm performance. Therefore, having a working definition will provide insight into, and lay the foundations for developing a reliable report that will demonstrate a thorough and comprehensive understanding of the relationship between corporate governance and firm performance.

Initial efforts to define the concept have materialised in the Cadbury Committee Report (1992) and the South African King Report (1994), whereby corporate governance is narrowly defined as ‘the system by which companies are directed and controlled’. Following this, Sir Adrian Cadbury (World Bank Report, 1999: 7) established a more dynamic definition whereby corporate governance is:

> Concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources.

The trend to define corporate governance continued into 2004 whereby the Organisation for Economic Co-operation and Development (2004: 7) broadly defined corporate governance as:

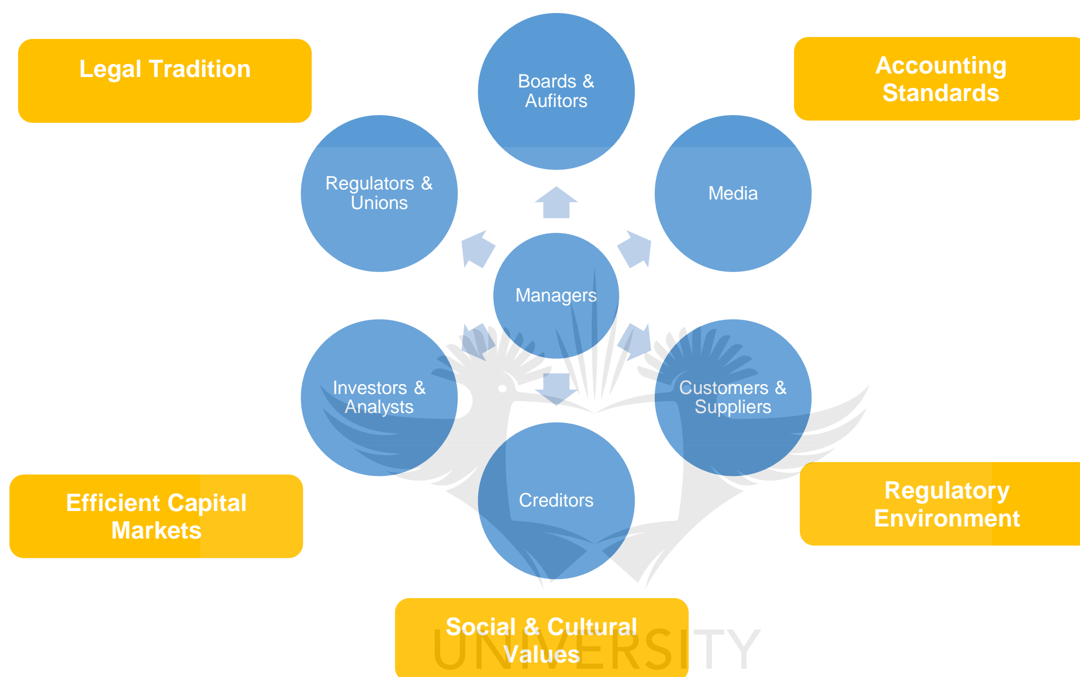
> A set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined.

Allen (2005: 164) contributes to the definition of corporate governance by stipulating a narrow view and a broad view. A narrow view is concerned with ensuring that the company is performing in the interests of the shareholders, and a broader view is focused on ensuring that society’s resources are utilised effectively. Rossouw et al., (2002: 290) echo these definitions whereby the narrow conception of corporate governance is the internal governance of the institution, while a broader notion refers to external control exerted over companies. Allen (2005: 165) purports that the approach of running a firm solely in the interests of shareholders

is too narrow. When markets are incomplete and imperfect, as in many developing economies, having an objective function for firms that is alternative from the narrow view, will enhance the allocation of resources.

Figure 2.2 depicts the varying determinants and participants within corporate governance systems. Governance systems are shaped by a wider group of constituents namely the owners of the firm, creditors, unions, customers, suppliers, the media and regulators.

FIGURE 2.2: Selected participants and determinants in corporate governance systems



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Source: *Larcker and Tayan (2011: 9)*

Figure 2.2 demonstrates that corporate governance includes both internal corporate structures and external corporate governance systems and stakeholders. As explained, internal corporate governance structures include shareholders, the board of directors and the executive management. Rossouw (2009: 7) affirms that local standards of governance have a tendency to shift towards internal corporate governance and as such provide principles, codes and procedures which companies can employ in a voluntary self-regulatory manner. External corporate governance mechanisms consist of the legal system, regulators, local communities, political, social and economic policies within which corporations operate (Rossouw et al., 2002: 290). External governance is mandatory and companies which do not conform, can run the risk of being sanctioned through fines or expulsion (Rossouw, 2009: 7).

Table 2.1 demonstrates the difference between internal and external corporate governance definitions.

TABLE 2.1: Corporate governance definitions

VIEW	DEFINITION
Internal corporate governance (Narrow view)	'Control exerted by a board and executive managers over the performance of a company.' The strategic direction of the company should ensure that the company complies with the formal and informal standards of corporate behaviour.
External corporate governance (Broad view)	'Located outside of the corporation either in regulatory institutions, societal norms or in the market itself.' Regulatory institutions determine the parameters within which corporations pursue their corporate objectives.

Source: *Conceptualised from Rossouw (2009: 7)*

Corresponding to the broad definition, Claessens (2006: 94) observes that the purpose of a good governance structure is to maximise the contribution of companies. Furthermore, it should incorporate corporate social responsibility which encompasses the company's dealing with respect to culture and the environment.

Ultimately, Sullivan (2009: 5) provides the best description and definition because he succinctly describes corporate governance in its entirety:

> Corporate governance typically addresses measures to manage and reduce financial and operational risks by building the integrity, transparency and accountability of a company's management towards different actors at varying levels within a company.

2.3 THE MAIN THEORETICAL MODELS

Most of the latest discussion on corporate governance has focused on everyday concerns such as corporate fraud, the exploitation of managerial power, and social flippancy. Effective mechanisms and measures should be put in place in order to combat perceived issues within corporate practice and to fulfil the expectations of shareholders. In concurrence with this discussion lies a deliberation on the theoretical framework and the quest for the most ideal theoretical model of corporate governance (Letza, Sun & Kirkbride, 2004: 243).

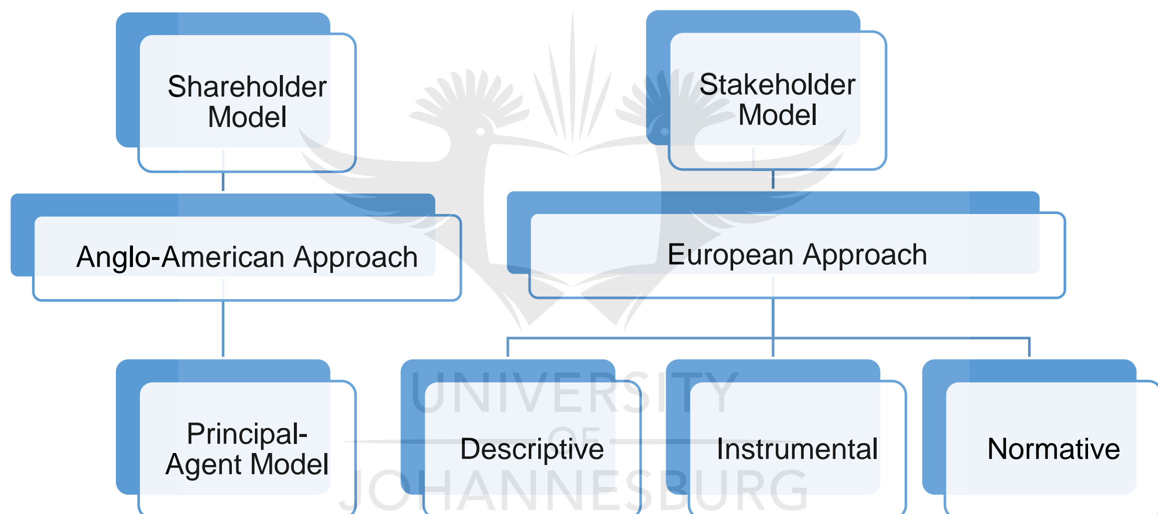
The debate is centred on fundamental questions that examine the purpose of the corporation, and who and how a company should be controlled. Ultimately, corporate governance from a

theoretical perspective is concerned with understanding the interactions between numerous economic and corporate contributors (Letza et al., 2004: 242).

Some of the present viewpoints on corporate governance have been characterised into two divergent theories namely the shareholder model and the stakeholder model. The following section examines the basic assumptions and conjectures of the shareholding and stakeholding frameworks. Andreasson (2009: 650) identifies that the characteristics of a company and to whom it is ultimately responsible, provide a basis from which to debate and gain a detailed understanding of the concept of corporate governance.

Figure 2.3 presents an overview of each of the shareholder and stakeholder models. The Figure serves as a simplified representation of each subsection within each model which will be sufficiently discussed and reviewed in detail.

FIGURE 2.3: Breakdown of Shareholder and Stakeholders Models



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Source: *Conceptualised from West (2006)*

The debate between the two models is centred on the objectives of the corporation and its associated structure of governance standards comprehended and vindicated in theory. The traditional shareholding framework, which considers the corporation as a legal instrument from which shareholders can generate investment returns, is one side of the debate (Letza et al., 2004: 243). The other is the shareholding perception whereby the company is deemed as locus in relation to wider external stakeholders interests. Employees, suppliers and customers are emphasised within the broad definition of stakeholding.

As portrayed in Figure 2.3, it is imperative to identify that the models have different country and legal origins. Typically the shareholder model tends to be more commonplace in Anglo-American countries, such as the UK and the US with common law origin. The stakeholding model tends towards the European approach, which is prevalent in Continental Europe and Asia (West, 2009: 33).

Extant literature suggests that these two models are based on fundamental variances in theoretical assumptions, major features, solutions and weaknesses (Andreasson, 2009). The corporate governance landscape is shaped by all of these characteristics. The structure of these models provides the basis from which companies can implement basic rules that are in the best interests of shareholders and stakeholders, and will also ensure an efficient market that does not crash as a consequence of corporate collapses.

2.3.1 Shareholder model

The shareholder model is based on the premise that the onus of the corporation is to maximise shareholder value whereby successful governance policies can enhance equity holders' investments through suitably aligning manager and shareholder incentives (Larcker & Tayan, 2011: 9). West (2006: 433) extends this notion to convey that the shareholder model advocates that a company is merely an extension of its shareholders, whereby its overall objective is to deliver goods and services to customers for the benefit of the owners. This sentiment is supported by Rossouw (2009: 7) as he purports that the framework is primarily geared towards satisfying the interests of shareholders. Furthermore, Maher & Andersson (1999: 6) affirm that the primary aim of this model is to employ allocative and productive efficiencies in order to raise shareholder wealth.

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Letza et al. (2004: 247) assert that the shareholding perspective originated from the fundamental ideals of individual private ownership. Private ownership is considered to be central to a desirable social order and an efficient economy. In this way private ownership rights are sacrosanct to the concept of corporate governance. Moreover, a company has a legal obligation to act in its shareholders' interests, whereby managers are also expected to be held to this obligation (Letza et al., 2004: 247). If a company acts against its legal obligation towards shareholders, then this gives managers the opportunity to rationalise their abuse of power.

Hayek (1969) extends this rationale to incorporate the view that efficient economic undertakings are effected through individuals who possess private property and engage in their self-interests. However, Letza et al. (2004: 247) emphasise that if a corporation operates

for any social reason that does not serve shareholders' interest, it will afford a basis for managers to justify their exploitation of power which will result in the inefficient allocation of resources.

In support of the shareholder model, Rossouw (2009: 8) stipulates that the primary focus on shareholder interests versus other stakeholders of the corporation streamlines corporate decision making and enhances the efficiency of companies, which ultimately benefits all other stakeholders.

2.3.1.1 The principle-agent model

The segregation of finance and management is a fundamental issue that arises in modern companies (Berle & Means, 1932). The risk that managers would rather serve their own interests is heightened by the fact that shareholders are forced to allocate authority to several directors and managers to direct the company on behalf of all the shareholders. There is a possible risk that managers may serve their own interests at the expense of all the shareholders (Letza, et al., 2004: 247). Managers may have other operatives that include boosting their salaries, bias towards a particular project, or extending their market share.

Maher and Andersson (1999: 6) attest that if there is a division between ownership and control, then the intentions and goals of the principal (the investors) and the agent (managers) may differ. The separation of these factors causes the company's performance to be independent of the objective of profit maximisation.

Jensen and Meckling (1976: 309) stipulate that the principal-agent relationship exists at every level of management within an organisation. This suggests that managers may naturally utilise their power to maximise their own interest, which is not within the shareholders' best interests. In this way, agency costs arise as principals endeavour to guarantee that agents/managers act to benefit shareholders. Agency costs include monitoring expenses such as auditing, budgeting control and compensation structures.

According to Jensen and Meckling (1976: 310), the agency conundrum can be solved if suitable incentive schemes are in place. Maher and Andersson (1999: 7) build on this by reporting three kinds of processes that can be adopted to better align the objectives of managers with those of shareholders, namely:

- Managers can be incentivised through executive compensation plans which can include stock options, commissions and transfer of property rights.

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- Shareholders could strengthen their legal rights which may induce shareholders to better monitor management. This can be in the form of prohibitions against insider-trading or protection and enforcement of shareholder rights.
- The managerial labour market can also be used as a disciplinary tool on managerial expropriation.

An alternative solution to these suggestions has been proffered by financial economists who demonstrate that the most effective mechanism is market governance. Capital markets and potential take-overs deter managers from deviating from the overall objective of profit maximisation (Manne, 1965; Alchian & Kessel, 1962). This rationale is based on the premise that the current share price reflects the market value of all attributable profits and growth to the company. Therefore shareholders wealth is best served by maximising the share price indirectly as this is an independent indicator of corporate performance. The stock market valuation provides an objective assessment of management performance.

Essentially, the success of these solutions is dependent upon the balance between the cost of assessing behaviour (rewarding hard work and purchasing complete information) and the expense of quantifying outcomes (i.e. profitability) and shifting risk to the agent (Letza et al., 2004: 249).

2.3.1.2 Critiques of the shareholder model

Typically, the dominant form of companies is one characterised by concentrated ownership. A closely held corporation is often controlled by a majority shareholder or by a set of controlling blockholders. This could be in the form of individual or family blockholders (Maher & Andersson, 1999: 8). Therefore the issue for the closely held corporation arises not from shareholder protection or monitoring issues, but rather from cross-shareholdings or other ways that shareholders utilise to exert control, usually to the detriment of minority shareholders. For this reason it becomes imperative to safeguard the interests of the minority investors. This begs the question as to how policymakers amend regulations that do not only marginalise majority shareholders, but that also represent the interests of minority shareholders.

Maher and Andersson (1999: 6) go on to critique the shareholder model for being too limited in its application. The shareholder approach is primarily geared towards ensuring that managers and shareholders' objectives are aligned.

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However, shareholders are not the only parties that make contributions to the firm. The competitiveness of a company is the result of teamwork that encompasses investors, employees, creditors, suppliers, distributors and customers. It was on this basis that the broader stakeholder theory was developed.

2.3.2 Stakeholder model

The stakeholder perspective incorporates the belief that a company should not only serve to increase shareholder value, but also has a societal responsibility. Effective governance should encourage procedures that create constant and secure employment, generate a suitable standard of living for employees, diminish risk for debt holders, and enrich the local community and environment (Larcker & Tayan, 2011: 9).

In this way, the stakeholder model incorporates a broader geopolitical and psychosocial community view of the corporation. Letza et al. (2004: 250) observe that the modern company has significant scale and scope whereby companies are involved in various aspects of social life. It is imperative that companies realise the importance of their social commitments such as equality, justice and the security of employees. Maher and Andersson (1999: 8) declare that the company is accountable to a broader group of stakeholders, other than shareholders. Other stakeholders include suppliers, employees and customers' creditors (West, 2006: 434). Additionally, Hall (1989) posits that a company shares a collective identity whereby executives should serve all corporate stakeholders' interests.

Donaldson and Preston (1995) report three facets of the stakeholder theory namely descriptive, instrumental and normative. Instrumental stakeholder theory is the most prevalent viewpoint in stakeholder theory (Campbell, 1997; Parkinson, 1995; Cadbury Committee, 1992). This theory is founded on the basis that serving multiple interests of stakeholders improves efficiency, profitability, competition and economic success. Table 2.2 provides a summary of these three specific perspectives.

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TABLE 2.2: Summary of Descriptive, Instrumental and Normative Theory

THEORY	DEFINITION
Descriptive	Presents the observation that corporations have stakeholders.
Instrumental	Acknowledges that there is a responsibility towards stakeholders in order to achieve economic efficiency.
Normative	Recognises that stakeholders be considered as an end in themselves in terms of moral and community values.

Source: *Conceptualised from West (2006: 434)*

2.3.2.1 Critique of the stakeholder model

A difficulty associated with the traditional stakeholder model is that it is challenging to guarantee that companies fulfil these broader purposes (Maher & Andersson, 1999: 9). Blair (1997) articulates that there is a lack of clear guidance in order for management to determine where company resources would be socially advantageous. Furthermore, it has failed to enforce mechanisms that ensure companies are living up to their social obligations.

A reformed stakeholder model has been developed to combat these downfalls whereby the importance of concisely defining what represents a stakeholder, has been stressed. This reformed stakeholder approach is ultimately a natural augmentation of the shareholder model. Corporate governance in this broader context is aimed at developing systems that elicit company-specific investments where stakeholders are actively encouraged to create wealth, jobs and develop financially sound entities (Maher & Andersson, 1999: 9).

2.3.3 Shareholder vs stakeholder model

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The debate is centred on the shareholding perspective that encompasses private property and individual liberty, which encompasses the belief that the main aim of a company should be to maximise shareholder value. In comparison to this is the stakeholder model that is based on the notion that companies have a responsibility to society and are not only required to serve shareholders' interests. These polarised constructs are based on their own unique paradigms and ideologies that are universally valid and unchangeable (Letza et al., 2004: 252). One downfall of both models is their fixed assumption of an ideal social reality. This is often not the case, as reality does not have such a fixed nature and property. Letza et al. (2004: 251) reveal an interesting perspective between the instrumental stakeholder theory and the Anglo-American model, whereby there has been a paradigm shift toward stakeholding in the Anglo-American landscape from a shareholding perspective.

Model social circumstances are not easily replicated in practice, and it is not realistic to assume that ideal social circumstances will persist over time. Only process and change are absolute. Fligstein and Freeland (1995) postulate that there is no one universal governance system adopted by firms around the world. A structure should rather emerge through a dynamic process in which there are continuous interactions between the decisions implemented and their complex contexts (Mueller, 1995). Governance systems are a reflection of priorities, political inclinations and local conditions of a specific country. More specifically, the elemental orientation of a company and the part it plays within society, determine the structure of its governance framework.

Both the shareholder and stakeholder perspective attempt to simplify corporate governance, which is a dynamic and complex concept. Corporate governance needs to be adaptable, variable and original. Therefore, in order for theoretical models to be applicable and relevant in practice, a new mode of thinking in the analysis of corporate governance is needed to better explain the idiosyncratic workings of this concept within a local framework. Table 2.3 provides a summary of the shareholder and stakeholder models discussed.

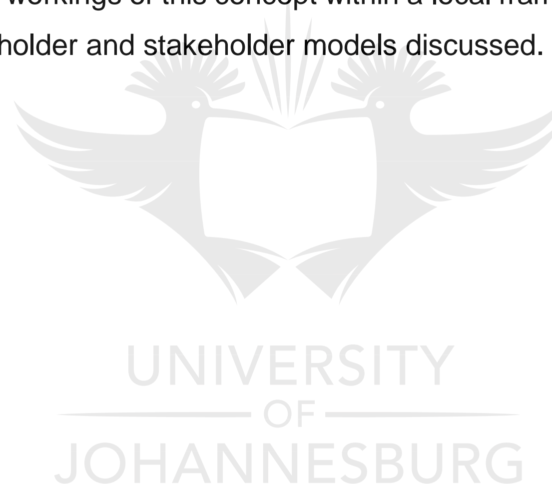
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TABLE 2.3: Overview of the shareholder and stakeholder theories

OVERVIEW	SHAREHOLDING MODEL	STAKEHOLDING MODEL
PURPOSE OF THE COMPANY	• Maximise shareholder wealth	• Maximise stakeholders wealth
BASIS OF MODEL	• Private ownership rights • Market efficiency	• Social efficiency within the economy
DIVISIONS WITHIN MODEL	• Principal-agent theory	• Descriptive theory • Normative theory • Instrumental theory
LEGAL SYSTEM	• Anglo-American approach	• European approach
TIME HORIZON OF ECONOMIC BENEFITS	• Short-term	• Long-term
REGULATORY ORIENTATION	• Self-regulation	• Statutory regulation
BENEFITS	• Streamlines corporate decision making	• Incorporates all stakeholders
DISADVANTAGES	• Model is too narrow-minded • Principle-agency problem	• Difficult to ensure companies fulfil wider objectives • No clear guidance and definitive system
POTENTIAL SOLUTIONS	• Implementation of incentive plans • Strengthen shareholders legal rights • Managerial labour market	• Narrowly defining what constitutes a stakeholder • New mode of thinking required to explain idiosyncratic workings

Source: *Conceptualised from Jensen and Meckling (1976); Keasey, Thompson and Wright (2005); Letza et al. (2004).*

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Shareholders and managers should have incentives that adopt longer-term performance objectives in order to improve corporate governance. These incentives include improving the loyalty of shareholders, reducing shareholder exit, and encouraging a long-term relationship with other stakeholders.

Zingales (2000: 1624) declares that the nature of corporations is continuously changing. Large conglomerates can be divided into numerous smaller or independent companies that operate within various countries. Financing is easily accessible within capital markets and physical assets are readily replaceable. Global competition has become fierce as the demand has increased for process innovation and quality improvement and as such, the human resource base becomes pivotal to a company's existence and progress. All of these characteristics blur

the boundaries of companies further. Zingales (2000: 1644) states that 'the changing nature of the firm forces us to abandon the illusion that firms' boundaries are clear cut and remain unchanged when we change the governance structure'.

2.4 THE DEVELOPMENT OF CORPORATE GOVERNANCE

Corporate governance has evolved into a common term as the corporate world and policymakers begin to recognise the possible repercussions of poor governance structures (Claessens, 2006: 91). Scandals and crises are a consequence of several systematic failures of corporate governance and the key reason it has become essential for economic advancement and well-being (Becht, Bolton and Roell, 2003). The structures and mechanisms of corporate governance have not only been shaped by corporate failures and financial crises, but by the increasing globalisation of financial markets through the advancement of technology and the development of legislative ruling within specific countries.

This section will review how a spate of significant financial collapses has shaped the development of corporate governance standards throughout the world. The prospective macroeconomic and distributive consequences in the aftermath of these specific events have forced the corporate sector and policymakers to acknowledge the impact of bad governance structures (Claessens & Yurtoglu, 2012: 12). It is for this reason that this section will dissect how potential deficiencies within corporate governance have been addressed by policymakers and regulators. Developments within the United States, United Kingdom and the OECD policies will be briefly evaluated. This evaluation is important to demonstrate how foreign advances underpin the validity of the South African King Reports and how South Africa's corporate governance fares on an international scale. Furthermore, it is imperative to consider how the integration of worldwide financial markets has altered the landscape of the financial industry and how corporate governance policies have been shaped based on these advancements.

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2.4.1 The advancement of financial markets

A significant driving force behind the globalisation phenomenon is the rapid expansion and development of the financial sector and its growing impact upon many facets of the economy (Clarke, 2011: 5). Financial globalisation is characterised by the integration of more and more countries into the international financial system. The internationalisation of finance is being propelled by technological advances which consequently decrease the cost of communication and the processing of information. It is for this reason that financial contagion has strengthened the transmission of cyclical impulses and shocks among economies.

Financial globalisation has become an important stimulus for reform. In concurrence with this sentiment, Khanna and Palepu (2010) state that the key drivers behind the establishment of corporate governance policies are globalisation and the integration of financial markets. It is for this reason that numerous countries have introduced standards with which companies can voluntarily comply (Guillén 2000; Nestor and Thompson 2000). Aguilera and Cuervo-Cazurra (2009) show that governance systems are increasingly prevalent in more liberalised countries where there is a large foreign institutional presence. Countries with weak legal protections do not prioritise the revision implementation and update of their codes.

The increased volatility being felt throughout the world is attributable to the increasing globalisation of the global economy which can be seen in the growth of capital markets and most notably, the rapid expansion of equity markets where volatility has been experienced the most (Clarke, 2007: 7). The American equity markets (NYSE and NASDAQ) have seen exponential growth from a market capitalisation of $4 000 billion in 1990 to $28 297 billion in 2013 (World Federation of Exchanges, 2014). Similarly, the European markets increased from $2 000 billion in 1990 to $17 483 billion in 2013 (World Federation of Exchanges, 2014). This goes to show that countries are becoming more dependent on international capital flows to generate economic growth. This evolution is attributable to the gradual development of technology that has occurred since the 1980s. Moreover, companies that attract foreign interest need to have internationally recognised governance policies whereby investors are reassured their investments are in well governed hands.

2.4.2 Events that have shaped corporate governance procedures

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Clarke (2004: 153) indicates that corporate governance is ultimately cyclical. During periods of recession and corporate failures, there is a rise in regulation and reform. Whilst during periods of expansion, shareholders are primarily concerned about the accumulation of wealth as opposed to ensuring that governance codes are adhered to in order to retain this accumulated wealth (Du Plessis et al., 2010: 450). For this reason the historical progression of governance has been punctuated by periodic crises. The following Table provides a brief overview of events that have impacted corporate governance policies throughout the years.

The following cases illustrate the ineffectiveness of governance systems which are designed to prevent executives from abusing their power. In this day and age governance collapses are not isolated incidences. In recent years, several corporations have collapsed namely Bear Stearns, Lehman Brothers, Tyco and WorldCom (Larcker & Tayan, 2011: 3). This list is not exhaustive, in that it does not comprise of the smaller companies that were not mentioned on

the front page of the newspapers, but it encapsulates the highest profile cases with the most risk to shareholders and stakeholders. Furthermore, these issues are not limited to U.S. companies. Large conglomerates such as Polly Peck, Parmalat and Royal Dutch Shell have been embroiled by dilemmas dogged by a lack of management oversight (Larcker & Tayan, 2011: 4).

The discussion of these cases highlights the growing impact that specific company collapses have had, and how their failures have been heightened by the globalisation of financial markets in recent years. What is apparent from Table 2.4 is that the breakdown of a particular company not only affects the performance of the corporation in question, but also contributes to the vulnerability and risk inherent within the financial system within which it operates. This risk is also translated into other establishments and could indirectly have an adverse effect on their performance. The silver lining is that regulators and policymakers look to strengthen any weaknesses within their governance standards so as to avoid the repetition of history.

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Table 2.4: Review of Crises and corporate collapses that have shaped corporate governance reforms

DATE	EVENT	BACKGROUND	FAILURES	LESSONS
1990	**Polly Peck**	• Polly Peck was a British textile company that expanded exponentially through acquisitions. • Asil Nadir was CEO and by 1990 Nadir had stolen up to £29m from the company. • The company collapsed in 1990.	• Nadir was able to make payments without board approval. • These payments were made to companies owned or controlled by Nadir and his family. • Profits generated were through a convoluted and unclear structure. • Cash reserves were trapped in Turkish banks that could not be remitted to the UK. • Investments in depreciating developing currencies went undetected in the financial statements.	• One of the significant corporate scandals that instigated the 1992 Cadbury report. • The complexity of the business and its financial transactions led to the necessity for the development of transparent, regulated and concise financial reporting. • The delegation of too much power to one person can be detrimental to the well-being of the company. • The fact that the company was investing in high risk emerging economies highlighted the need for the development of adequate risk management procedures.
1997	**Asian crisis**	• The Asian crisis was initiated by the floating of the Thai baht in July 1997. • Shifting outlooks led to the depreciation of most other currencies in Asia, bank runs and rapid withdrawals of foreign private capital forcing an economic downturn. • The close integration of the Asian economies aided the spread of the crisis to other continents.	• Weaknesses in corporate governance and lack of market discipline enabled reckless risk taking. • Weak accounting standards helped hide the growing weaknesses inherent within the system. • Inadequacies in assessing country risk on the part of the lenders. • Inflated asset prices stimulated further capital inflows and lending, often by weakly supervised nonbanking financial institutions.	• Tighter rules for loan classifications, loss provisioning, and interest suspensions. • Adoption of improved valuation procedures with the best available data. • Strengthening viable institutions by means of asset valuation, loss recognition, and recapitalisation. • More transparency in macro and microeconomic data and policies. • Better development of regulatory and supervisory frameworks.
2001	**Enron**	• Enron was founded in 1985 and by 2010 had become one of the largest electricity, natural gas and communications company around the globe before it declared bankruptcy in December 2001. • Enron revised its financial statements for the previous five years and discovered $586m in losses.	• Lack of transparency about the state of the company. • Lack of independent oversight of management by the board. • Enron's compensation policies encouraged short-term behaviour. • The company utilised special purpose vehicles (SPVs) to borrow large sums of money without having to report the debt on its financial statements. • Failure of corporate auditing.	• Better oversight by the company's auditor. • Tighter regulation of auditing procedures. • Accountability of auditors. • The adoption of an independent and honest auditing company. • SPVs must be reported in the financial statements. • A culture of consistency and sustainability should be encouraged.
2002	**WorldCom**	• WorldCom was the second biggest telecommunications corporate within the United States. • The company classified over $3.8bn in payments or line costs as capital expenditures rather than current expenses. • The company filed for bankruptcy on 21st July 2002.	• Line costs that were costs linked to third-party network resources and facilities were incorrectly accounted for as capital expenditures. • This falsely inflated the company's net income and EBITDA. • Accounting procedures did not follow those of generally accepted accounting principles (GAAP). • Internal emails indicated that the Company's executives knew as early as 2000 that the accounting treatment was incorrect.	• This collapse spurred regulators to support tougher penalties for financial fraud. • Line expenses should be recognised in the period incurred. • Auditors should be held accountable. • Strong external and internal control mechanisms should be put in place. • The soundness of information within the financial statements is based on the level of independent audit assessments. • Rotation of company's auditors every five or six years. • Disclosures of non-audit fees should be made available.

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DATE	EVENT	BACKGROUND	FAILURES	LESSONS
2002	**Parmalat**	• By 2002, Parmalat was the largest distributor and producer of dairy products and beverages. • The company's CEO and chairman was Calisto Tanzi. • On 27 December 2002 Parmalat was declared insolvent. • Parmalat's former chief financial officer, Fuasto Tonna admitted that he benefitted from subsidiary contributions and kickbacks from the Swedish packaging group, Tetra-Pak.	• In 2003, bondholders discovered that nearly €4bn of funds in a Bank of America account were non-existent. • The transfer document of the account was a forgery. Parmalat was forging documents that purported to show large cash balances within its subsidiaries. • Management also destroyed documentation and hardware implicating the company in bank account forgery. • Non-core businesses purchased by the Tanzi family had generated enormous amounts of debt. • The company disguised shortfalls, exaggerated assets, documented fictional assets, devalued debt levels and redirected contributions to the Tanzi family. • Fictitious trades and financial transactions were engineered to offset losses of operating subsidiaries and to inflate assets and incomes.	• The independence of the board should be authenticated annually. The fact that a majority of the board comprised of Tanzi family members enabled the company to invest in non-core businesses that were highly leveraged and not in the best interests of the business. • Companies must implement a code of ethics, which places strict controls on insider dealings to prevent officers, directors and employees from self-enriching trading. • The positions of chairman and chief executive officer should be held by separate individuals. • Stricter rules and harsher fines should be enforced against employees who commit fraud. • Regulators and banks should have realised the true nature of the information provided by the company. • Better standards should be enforced so that the financial soundness of an institution can be effectively evaluated. • Liability for prosecution for mismanagement should be clearly stated.
2002	**Tyco Internation al**	• Tyco International was originally an investing and holding company that evolved into a publically traded entity focusing on high-tech research and development. • Dennis Kozlowski was CEO and chairman. • The U.S Securities and Exchange Commission accused Tyco of improper acquisition accounting during the period from 1996 to 2002. • Dennis Kozlowski and Mark Swart (CFO) defrauded shareholders of over $400m between 1996 and 2002.	• Lack of supervision by senior management. • Improper auditing and fraudulent disclosure of accounting practices. • Personal loans were never approved and were kept off the financial statements of the company. • Documents that were related to the loans granted were falsified. • The company improperly used various types of reserves to make adjustments at the end of reporting periods to enhance and smooth publically reported results and to meet earnings forecasts.	• The CEO and CFO were charged with 22 counts of grand larceny, false business records and conspiracy and securities fraud. • Adequate policies and procedures should be adopted in order to prevent misconduct by senior management and executives. • Executive remuneration should not be reckless and excessive. • Executives and senior management need to be held accountable and responsible for any conduct that is not in the interest of the company.
2004	**Royal Dutch Shell**	• Royal Dutch Shell has maintained its reputation as one of the leading global corporations. • In January 2004 the company was found to be guilty of overstating its oil and gas reserves. • The reported 2002 figure of 19.5bn barrels was diminished by 4.47bn barrels.	• In 2002 management recognised that Shell did not fund enough oil to supplement production. This was a key indicator of Shell's future profitability. • Shell was stuck with a number of small fields which was not enough to keep up with its production requirements. • Shell's decentralised management became a weakness. Different practices were adopted.	• Over-optimistic forecasting can be detrimental to the profit generation of the business and investors' expectations of growth. • Decentralised management should have a common policy that stipulates effective guidelines and responsibilities. • Executive bonuses should not be inextricably linked to high targets. • Overstating resource can lead to inflated share price.

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DATE	EVENT	BACKGROUND	FAILURES	LESSONS
006	**Siemens**	• Bribes amounting to EUR1.3bn were paid in the form of provisions from illegal slush funds. • These payments were initiated to win contracts around the world. • The company agreed to a fine of €600m, the largest international for a company accused of overseas bribery.	• Money that was given to foreign purchasing officials was reported as having being paid to foreign consultants by Siemens. • These payments were inclusive of bribes paid to Israeli officials for power station contracts, Russian traffic control structures and deals conducted for the 2004 Athens Olympics in Greece. • Around 300 employees of the company were accountable for bribes paid to business partners, lower level government offices and even to governments.	• The case highlighted the need for regulators to scrutinise misbehaviour that is tolerated by managers. • Concise and well-defined policies should be implemented by mangers and distributed to employees in jurisdictions that are susceptible to corruption. • Potential intermediaries should be vetted through effective due diligence procedures. • Ethical leadership should be highlighted within performance management criteria. • Regular independent audits. • Sufficient financial control mechanisms. • Employees should have the ability to report their concerns confidentially.
2008	**Bear sterns**	• Bear Stearns was an investment bank that also offered security trading and brokerage services. • It had been operating for 85 years when it collapsed in March 2008. The company was subsequently purchased by JP Morgan Chase.	• The securitisation of subprime mortgages. • Increasing its exposure in 2006 and 2007 in order to increase its market share. • Weak supervision enabled employees to undertake reckless amounts of risk. • Did not ensure that there was sufficient capital to guard against the risks it undertook. • Inability to accurately measure the amount of risk it assumed.	• The risk profile of the entity should be evaluated through a credit risk management process. • Banks should be supervised by an effective system that has concise objectives and duties. • The enforcement of prudent capital adequacy ratios by banks.
2008	**Lehman Brothers**	• The collapse of Lehman Brothers' was one of the biggest corporate failures with approximately $639 billion in assets and $613 billion in liabilities. • The company was a specialist in the over-the-counter derivatives market. • Lehman Brothers was party to over 900 000 derivative contracts when it went bankrupt.	• The bankruptcy and consequent insolvency of the company had a significant impact on financial markets throughout the world. • The company had undertaken business ventures throughout the globe. • Lehman was the most aggressive underwriter of mortgage backed securities in the US with a portfolio worth over $85 billion. • The company's leverage ratio was 31 in 2007.	• Market, credit and liquidity risks should be accurately quantified and measured by market participants. • Participants who are party to derivative contracts are being placed under increased scrutiny by clients. • The sufficient safeguarding of investors assets and trade obligations is required. • Boards and management must have the necessary expertise to effectively monitor and supervise market and credit risks undertaken by the company.

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2.4.3 United Kingdom

The UK is considered to be the world's sixth largest economy and is founded on robust political, legal and regulatory institutions. The UK has some of the best governance standards in the world and it is for this reason that the development of the continent's corporate governance system will be examined. This section will concentrate on the formation of the Cadbury Report in 1992 and the subsequent developments following its implementation. Furthermore, this section will consider the motivation guiding the codes and detail criticism which the codes attracted.

2.4.3.1 Cadbury Report (1992)

The Cadbury Report was published in December 1992 (Keasey et al., 2005: 22). Essentially it was a compilation of uniform standards which were developed by the Cadbury Committee. The committee was comprised of the Financial Reporting Council, the London Stock Exchange and the accounting profession (Cadbury Committee, 1992). The British government initiated the report in an effort to increase the level of confidence in financial reporting and auditing. This, after a spate of corporate collapses in the 1980s and 1990s.

The Code of Best Practices set a benchmark for governance policies. (Cadbury Committee, 1992). Table 2.5 demonstrates the key recommendations of the Cadbury Report.

TABLE 2.5: Key recommendations of the Cadbury Report

ASPECT	RECOMMENDATION
CHAIRMAN AND CEO	The role of chairman and CEO should be segregated. There should be a strong element of independence if both positions are held by one individual (i.e. majority of independent non-executives directors).
NON-EXECUTIVE DIRECTORS (NEDs)	NEDs should not partake in any business or other associations that may have a material impact on their ability to make independent judgements.
EXECUTIVE DIRECTORS	Contracts should not be longer than 3 years in the absence of shareholder approval.
REMUNERATION	Full disclosure of director's remuneration. The remuneration committee should objectively decide on executive directors' remuneration.
AUDIT COMMITTEE	Boards should establish an audit committee that is independent and comprises of at least three NEDs.

Source: *Conceptualised from Keasey et al. (2005: 25).*

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The London Stock Exchange and the New York Stock Exchange incorporated these standards into their listing requirements. The Code of Best Practice was voluntary but companies listed on the exchange were required to include a statement in their financial statements outlining their compliance with the Code (Keasey et al., 2005: 25).

Keasey et al. (2005: 24) criticised the Cadbury Report for being excessively focused on the financial features of governance. The Report failed to address how the board should incorporate ethics and social responsibility into their day-to-day operations. Furthermore it was argued that the Code represented disruptions to the regular management of a company which put the economic success of a firm at risk. Lawrence (1994) contended that the Report was 'a bureaucratic response that many considered not actually effective but that would certainly be costly'. There is a trade-off between enforcing accountability for the greater good of shareholders and overtly imposing regimes that stifle business activity.

Furthermore, Keasey et al. (2005: 29) suggest that a major failing of the Code was its reliance on voluntary compliance. There should be enforcement mechanisms such as legal statutes in place in order to fully protect shareholders and stakeholders alike. However, this approach may be limited with regard to the regulation costs of regulation and indirect costs of constraints involved. Blair (1995) offers an alternative perspective that adequately confronts these criticisms. Blair (1995) stipulates:

> The truth is that corporate governance is more about commitment than compliance. The real solution resides with the board which must lift its integrity and raise its standards and its performance.

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2.4.3.2 Combined Code (1998) and UK Corporate Governance Code (2009)

The combined code was published in 1998 and later revised in 2009 (du Plessis et al., 2010: 317). One of the revisions in 2010 was that the Combined Code would be renamed the UK Corporate Governance Code. Essentially, the Combined Code encompassed the principle of full disclosure whereby all pertinent aspects of corporate governance structures and practice would be divulged. The Code represented a shift from a narrowly defined approach that emphasised the principle of accountability to a more balanced approach. It recognised the necessity of developing structures and incentives that encourage business enterprise and economic growth.

The regular review of the UK Corporate Governance Code has ensured that it remains relevant amid changing governance concerns and economic circumstances.

2.4.3.3 Current developments in the United Kingdom

Keasey et al. (2005: 39) advocate that recent government initiatives signal that governance policy in the UK may undergo a fundamental transformation. As mentioned, the approach, since the implementation of the Cadbury Report, has been 'comply or explain'. Whilst this perspective still holds true within the policies developed, it is evident that the government is taking a more proactive stance in the debate on governance. Their participation in the Modernising Company Law White Paper and Directors' Remuneration Regulation is proof of this. In addition there is a belief that self-regulation may be failing to deliver accountability, hence the need to become involved at a legislative level.

2.4.4 United States

The USA is one of the most dominant world economies whereby developments in corporate governance invariably influence advances in other countries (du Plessis et al., 2010: 299). For this reason, the next section will analyse the country's corporate governance frameworks, starting at the initiation of the Sarbanes-Oxley Act and concluding with subsequent developments. Additionally, one of the most pertinent events within the financial history of the world was the financial collapse of 2008 that originated in the United States. This review would not be complete if a discussion on the origination, impact and consequences of this collapse were not reviewed.

2.4.4.1 Sarbanes-Oxley Act (SOX)

The legislation of the Sarbanes-Oxley Act in 2002 restored national confidence in the regulation of listed companies (Finegold, Benson & Hecht, 2007: 866). A Public Accounting Oversight Board was created whereby renewed regulations and requirements were mandatory of public companies. Consequently, CEOs and CFOs who are found guilty of misrepresenting the financial statements, will face criminal punishments (Larcker & Tayan, 2011).

The instigation of SOX was driven by a number of corporate collapses that occurred within the US, in particular Enron and WorldCom. Du Plessis et al. (2010: 308) confirm that these corporate failures were the result of lax accounting and corporate governance practices. As observed by Tricker (2008: 108), SOX was a pivotal turning point in the history of governance regulation as it marked the fact that the US and UK no longer shared similar foundations. SOX was developed on the foundations of a rule-based legal approach to governance whereby the sentiment 'comply or else' is shared, whereas the UK approach is based on a non-prescriptive, principles-based, self-regulatory approach (du Plessis et al., 2010: 307).

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Despite the legal enforcement of SOX, there were still a number of weak governance practices that remained within the financial system. These ill-fated corporate governance practices were largely to blame for the global financial crisis which was sparked by the rapid deterioration of the US financial markets in 2008. The regulatory hard-law of SOX was criticised by supporters of a self-regulatory model for failing to prevent the global crises (King Report, 2009). Additionally, du Plessis et al. (2010: 309) contend that the expense associated with complying with SOX far outweighs its effectiveness. In contrast, Tricker (2008: 109) implores that the benefits of complying to SOX are improved accountability of human capital, decreased risk of fraud, and more transparent financial statements.

2.4.4.2 Legislation arising from the global financial crisis

The breakdown of the US housing bubble in 2006 and the subsequent subprime mortgage crises in 2007, incited the global financial crisis (Sun et al., 2012: 3). The crisis was marked as a housing and financial crisis that was the result of an upsurge in mortgage foreclosures, a substantial decrease in the value of mortgage-backed securities, and a considerable decline in the level of capital and liquidity available within the financial market. A domino effect played out as the financial crisis rapidly spread to other sectors and countries as the European real-estate sector collapsed and numerous economies around the world flagged. The global recession and European sovereign debt crisis were consequences of this.

Osterlou, Frey and Zeitou (2011: 54) recognise that many companies were not prepared to deal with the shocks stemming from the financial crisis. This can be attributed to overly simplistic or optimistic scenarios in their stress testing models. Sun et al. (2012: 3) stipulate that market participants did not have an adequate appreciation of the risks of seeking higher yields, and failed to exercise due diligence. Sun et al. (2012) highlights several reasons for the negligence in risk management:

- Fallacious risk management practices were implemented as financial products became increasingly complex and opaque. This coupled with excessive leveraging created a breeding ground for vulnerabilities.
- The board of directors was pressurised into adopting ill-fated strategies with short-term horizons by investors and executives. These pressures were encouraged by misaligned compensation packages that focused on short-term performance which led to excessive risk taking.
- Directors were often uninformed as sensitive information was not rapidly communicated to the board. In many companies, directors were unaware of the increase in credit risks, nor did they have a thorough understanding of the consequences of the risks undertaken by management.

- Policymakers and regulators failed to address the risks building up in financial markets, and they were outpaced by financial innovation which resulted in inadequate policy making.

Sun et al. (2012: 7) accede that corporate governance reform in developed countries has generated beneficial outcomes such as independent boards and shareholder activism. However, they also acknowledge that not only were governance systems unsuccessful in preventing the crisis, but it also enabled corporations to take reckless financial risks for short-term profit maximisation. This suggests corporate governance issues are not a result of the implementation thereof, but are rather rooted in systematic and fundamental problems with regard to the standards. Maher and Andersson (1999: 11) contend that one weakness of this systematic approach is that it is challenging to quantify the interactions between various sectors of the economy. The structure and features of an economy should be carefully considered when assessing the governance capabilities of companies.

2.4.4.3 Current developments in USA

The development of a Shareholders Bill of Rights in 2009 took place to give shareholders greater power over director elections and compensation (Larcker & Tayan, 2011: 11). Following this, the 2012 Dodd-Frank Wall Street Reform and Consumer Protection Act implemented a number of regulations within this Bill. Larcker and Tayan (2011: 12) question the legislature's legitimacy that is an outcome of political expediency, or is founded on exact theory and thorough empirical research.

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Another recent development can be realised in the establishment of a number of third-party organisations such as The Corporate Library and Risk Metrics Group, whereby individual companies are rated on their corporate governance policies. These rating agencies are ranked by a series of criteria that measures governance effectiveness. Larcker and Tayan (2011: 13) question the accuracy of these ratings as it encourages a 'check-the-box' approach to governance that ignores the importance of context.

2.4.5 The OECD

The Organisation for Economic Co-operation and Development is made of a group of 34 member countries which share a common allegiance to a democratic society and a market economy (du Plessis et al., 2010: 338). The OECD developed a set of principles in 1999 which were further refined in 2004 in light of the corporate scandal of the late 1990s and early 2000s (du Plessis et al., 2010: 338). The principles comprise of six key areas namely:

1. The elements that make an effective corporate governance framework
2. Shareholders' rights

3. Shareholders should be treated equally
4. Stakeholders' role in terms of governance
5. Transparent and concise disclosure
6. Board obligations

One of the primary goals of the OECD principles is to better governments' legal and regulatory governance structure. The fact that the principles are not limited by a specific corporate law system or board structure, means that the system can be applied in all countries. Furthermore, they have become the international benchmark for corporate governance as they have been endorsed as one of the Financial Stability Forum's twelve key standards for financial stability (Jesover & Kirkpatrick, 2005: 4).

2.4.5.1 Current developments of the OECD

The OECD Corporate Governance Committee is conducting a further review of the OECD Principles of Corporate Governance. The review process started in 2014 and was supposed to be completed within 1 year (OECD, 2014). By incorporating the latest advances in the corporate sector the Principles are of a high standard, relevant and useful.

Corporate governance will be further developed and refined flexibly and dynamically, not only to prevent or mitigate any financial crisis in future, but to also create a better society on a global scale. Since corporate governance frameworks are historically contingent and rooted in cultural, historical and legal differences, the development of South Africa's governance system will be analysed in the subsequent section.

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2.5 CORPORATE GOVERNANCE IN SOUTH AFRICA

This section will aim to provide context to the research question with respect to South Africa. There are three reasons as to why this section will be reviewed. Firstly, as emphasised, context matters and for this reason South Africa's corporate governance policies and development thereof, will be critically assessed. Secondly, in order to answer the research question at hand, one needs to be able to understand the frameworks that guide South African companies' ethical and governance standards. Thirdly, South Africa presents a remarkably unique case from which to study as it is a pioneer in corporate governance reforms within sub-Saharan Africa. This analysis will aim to provide better insight into whether corporate governance has a significant effect on South African company performance.

The first section highlights the plight of emerging economies and the drive to enforce corporate governance standards. The following section addresses the King Reports and the development of Black Economic Empowerment. Finally, recent reforms and developments will conclude the South African section.

2.5.1 Emerging economies

Aka (2007: 225) insists that if developing economies, specifically African countries, can adopt effective governance principles, then this will provide the foundation to safeguard against corruption and mismanagement which will encourage transparency and attract local and foreign investment. Furthermore, Aka (2007: 225) states:

> Corporate governance brings the values of democracy to the corporate level and ensures that effective rules of the game allow equal access and protection for all participating in economic life.

Reed (2002: 223) corroborates that developing countries should not only be concerned with issues of corporate failure and accounting fraud, but they also have to consider the effects on economic development and globalisation. In this way, West (2006: 435) stresses that an effective corporate governance strategy should achieve a balance between fulfilling local expectations and international pressures. Moreover, Reed (2002: 228) acknowledges that the impetus for governance reforms has deeper roots that originate from the past experiences of relevant countries and structural changes in the global economy. The implementation of corporate governance within developing countries can be contextualised in three elements. Table 2.6 depicts these elements.

TABLE 2.6: Optimal effects of corporate governance reforms

REFORMS	EXAMPLES
Increase in available investment opportunities	• Adjusting foreign direct investment limits • Promoting cooperative agreements between international and local companies • Enable current account convertibility
Instilling investor confidence	• Reforms to company law (strengthen shareholder rights) • Adjustments to capital markets • Strengthening of banking sector
Decrease rent-seeking behaviour by government	• Decreasing the size of state • Limit the number of interactions corporates have with government

Source: *Conceptualised from Reed (2002)*

Gibbs (2014: 1) stipulates that the quality of governance within developing markets will have several significant implications, namely:

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- Improved business confidence and a bigger appetite for risk.
- Increased capital inflows will encourage a more stable macro-environment.
- Greater levels of self-reliance and less exposure to spillover effects from major advanced economies.

Through the evaluation of emerging economies, one can recognise that developing economies not only face the challenge of maintaining financial stability, but also need to ensure that they sustain growth within their economies. The next section will guide this discussion with particular reference to South Africa.

2.5.2 South Africa

South Africa exemplifies an intriguing case from which to review how governance standards have evolved. It is the second biggest economy in Africa and boasts financial institutions which rival those of developed countries (Andreasson, 2009: 654). One of South Africa's most distinctive features is that it has a dual economy with a developed, high-end economy coupled with a less developed, low-end economy functioning mostly in townships and informal settlements in urban areas and former homelands in rural areas (World Bank, 2013).

The country's financial sector has evolved into a sophisticated and well-established division of the economy whereby private sector lending and equity market rank among the deepest in the world. Its development is deeply-rooted in equity as corporates rely heavily on equity finance and often turn to the large domestic equity market for funding (Malherbe & Segal, 2001: 7).

The South African economy has become substantially more diversified, as it once was highly dependent on commodities such as gold and diamonds (Aka, 2007: 230). Armstrong, Segal and Davis (2005: 14) observe that the increase in investor activity by local and foreign investors has made the financial services sector a pivotal part in the economy. From a corporate point of view, South Africa is seen amongst its listed firms as one of the best governing in the world today. This is reflected in the fact that in 2010 and 2011 the JSE was held to be, by the World Federation of Stock Exchanges, the best stock exchange in the world because of its listing requirements which includes the King principles on a 'apply or explain' basis (King, 2013). For this reason, a majority of private equity holders within the South African economy are international entities. This is a vote of confidence for the country's capital markets and financial infrastructure.

Yet despite these developments, South Africa is still plagued with inequality issues as the richest 10% of households generate over half of the country's national income (Econometrix, 2014: 52). Andreasson (2009: 655) warns that the country's political transition has not kept

pace with that of its economic transformation, as the unemployment rate is relatively high at 25.2% and even higher at 33.7% if discouraged workers are included (Econometrix, 2014: 51).

Similarly, Armstrong et al. (2005: 33) note that government is pressurised to increase the living standards of the entire population through more employment opportunities and social services. In order to accelerate this growth, the country will need to attract more investment from both domestic and international institutions and ensure that it is used effectively.

The South African Rand remains one of the most liquid developing market currencies. The Rand is the sixteenth most traded currency in the world and it is reported that some $27 billion worth of daily notional value is traded (Econometrix, 2014: 60). At times it trades as a proxy for expressing a view on the developing market universe as a whole. As such, foreign portfolio investment flows play a disproportionately large role in determining the balance of the current account (Haworth, 2014: 14). The current account deficit has expanded to between 5% and 7% of GDP, implying a foreign exchange requirement of around R200 billion per annum to make up the shortfall (Econometrix, 2014: 59). This implies that the key variable pushing and pulling the Rand is the level of foreign savings inflows into the SA economy, which are highly sensitive to domestic business conditions and risk-return profiles of SA assets relative to international assets.

In this way, corporate governance could be a key feature for ensuring the South African economy has a prosperous future. There is an ongoing need for structural reforms to sustain growth and bolster investors' confidence in the region. There should be a common aim to encourage increased foreign direct investment, industrial diversification, better infrastructure and human capital, and social protection to close the gap between South Africa and advanced economies (Gibbs, 2014: 2). If South Africa continues to pursue sophisticated measures, such as the King Reports, this will ensure that the country holds its place as a leading and attractive emerging market for international and local institutions.

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2.5.3 King Reports

The King Reports are arguably the world's leading corporate governance standards. The first King Report was drawn up in 1992 and subsequent reforms of it have been generated in the form of King II and King III. The ensuing sections will detail the background of the three reports. The Report is based on three primary provisions namely leadership, sustainability and corporate citizenship. The following important principles are underlined to provide a brief overview of what the Report is founded on (Institute of Directors in Southern Africa, 2009: 12):

- Good governance is encompassed by effective leadership. Being a good leader necessitates a clear strategy, defined direction, and the establishment of ethical codes that will regulate behaviour in terms of the sustainability of performance.
- Sustainability is a source of opportunity and risk. There is a significant shift in the way businesses conduct and organise themselves.
- If companies effectively integrate sustainability and social transformation reforms into the way they run their operations, this will illicit efficiencies and benefits that would not have otherwise been generated by fragmented businesses.

2.5.3.1 King I (1994)

The King Committee on Corporate Governance was established in 1992 and published King I in 1994 (Andreasson, 2009: 656). King I was the first of its kind in that it was the first formalised set of corporate governance principles pioneered by a developing economy (Waweru, 2014: 459). It also coincided with South Africa's reintroduction into the global economy and in many ways marked the broader economy's commitment towards better practice and market competitiveness.

Corporate governance reform was propelled by international governance principles and by the revolution of South African society and a deeper sense of cultural shift, which was coined as the African Renaissance (Waweru, 2014: 459). The African Renaissance was characterised by the growth and revival of Africa and the development of a free republic.

The King Report notes that the central focus of the governance system is the board (Waweru, 2014, p. 459). Following this, Vaughn and Ryan (2006: 506) mention that the key aim of the King report is to uphold the best standards of corporate governance based on the foundations of intellectual honesty. It was founded on several pillars of accountability, fairness, transparency and responsibility (King, 2013).

Andreasson (2009, p. 656) specifies that the Report was significantly influenced by the Cadbury Code in the UK. West (2006, p. 435) purports that this influence stems from South Africa's colonial legacy that has resulted in corporate law and corporate practice being significantly influenced by the United Kingdom. British tradition has firm roots in South African governance structures and corporate cultures.

2.5.3.2 King II (2002)

An inclusive approach to governance was created by a host of experienced parties in the private sector in the form of King II which was published in 2002 (Andreasson 2009: 657). The Code of Corporate Practices and Conduct is a principal element of King II. Triple bottom-line reporting in South Africa was first introduced by the Code. The result of this was the amalgamation of traditional reporting on the financial bottom line and alternative reporting on environmental and social sustainability of the company's undertakings.

A conspicuous aspect of the King Report (2002) is that it encompasses an inclusive approach to corporate governance. Rossouw (2005) and West (2006) share the view that South Africa's governance structures are historically orientated toward the Anglo-American approach. However, Waweru (2014: 459) asserts that recent post-apartheid reforms require local companies to explicitly adhere to various affirmative action and stakeholder issues. These include compliance with black economic empowerment, employment equity and HIV/AIDS corporate governance provisions.

The debate on the country's governance system would not be complete if the issue of black empowerment were not reviewed (Armstrong et al., 2005: 32). The Black Economic Empowerment initiative was initiated by the government to amend the disparity resulting from apartheid. The Broad-based Black Economic Empowerment Act was enforced in 2003 to address historical socio-economic imbalances by accelerating the pace of black economic advancement. More specifically the Act intended to provide a platform for black people to own businesses (Armstrong et al., 2005: 32). This could be a potentially limiting factor for efficient governance systems. The principles of good governance could be contravened by the adoption of rules that are founded on artificial financing structures. Therefore it is a difficult task to find an equilibrium between best business practices and affirmative action.

These requirements reveal the country's propensity to adopt key features of both the shareholder (Anglo-American) and stakeholder (European) models of corporate governance. Andreasson (2009: 656) contends that the King Reports could facilitate the adoption of a hybrid governance model. The combining of shareholder and stakeholder perspectives ensures that the unique aspects of African values and cultures are taken into account. This would have a stabilising impact on the country's economic environment. The effective implementation of a hybrid governance structure would set an example for other countries that also have similar issues related to uneven development and extreme inequalities.

2.5.3.3 King III (2009)

King III was an outcome of the new Companies Act (2008) and developments in international governance trends. The policies of the King Report are adhered to based on an 'apply and

explain' basis. The JSE requires the disclosure of the extent to which companies adhere to the Code and reasons for their non-compliance (Mangena & Chamisa, 2008: 5).

There are new provisions stipulated in King III that were not accounted for in King II namely:

- King III requires the disclosure of statutory financial and sustainability information in the integrated financial report.
- The effectiveness of internal financial controls should be validated regularly by an independent audit committee.
- IT governance is addressed in King III.
- It requires the board to disclose a remuneration policy to the shareholders.
- A section with regard to business rescue has been incorporated to address governance in rescue proceedings.

Appendix B provides a more detailed overview of the governance elements and principles set out in the Code.

2.5.4 Recent reform measures and developments

Armstrong et al. (2005: 23) highlight that developments in governance have manifested in South Africa in a number of different ways. The most notable development being the repositioning of South Africa's largest companies to international financial markets. These include the likes of Sasol, SABMiller, Old Mutual and Anglo-American. Companies which have expanded globally, have realised the importance of having good governance standards and as such have adopted those standards within their South African operations.

The emphasis by King III on prudent conduct has been integrated into specific legislature relating to financial markets (Armstrong et al., 2005: 23). The dissemination of current and relevant legislation is important within the policy landscape. Statutory regulations have been implemented to curb money laundering and corruption. The deterioration of South Africa's ranking in the global index is cause for concern.

The government embarked on a major overhaul of its corporate law regime whereby new legislation will offer a broader range of mechanisms for enforcement. Company law should encourage increased competitiveness and growth within the economy by:

- Fostering entrepreneurship and diversity of enterprise through the simplification of the formation of companies in order to decrease administrative costs associated with forming a company.

- An effective regulatory environment that should support innovation and investment in local markets and companies.
- Aiding transparency and high quality corporate governance disclosures.
- Ensuring compatibility with best practice on a global level.

Armstrong et al. (2005: 27) emphasise that a main concern for investors in developing countries is the lax enforcement of rules and regulations. South Africa has to demonstrate that it is a secure haven for international investors as growing impetus is being placed on globalisation.

There is potential for significant benefits to growth and broader socio-economic issues. Good governance stimulates the effective division of labour, improved productivity of investment, and efficient implementation of social and economic policies which are all significant drivers of sustained economic growth (Gibbs, 2014: 3).

2.5.5 Does one size fit all?

This section has continually highlighted that within a governance framework, context matters. A corporate governance system that functions well in one economy, may not prove to work in another. As an example, Germany necessitates labour union representation on most corporate boards. How effective would such a structure be in the United States? Furthermore, Japanese boards have few outside directors. What would be the effect on Japanese companies if they were required to adopt the independence standards of the United States (Larcker & Tayan, 2011: 14)? Ultimately, corporate governance is a fundamental concern with the purpose of the corporation and how the corporation could be better governed to serve society and the entire economy, apart from making profits for shareholders (Sun et al., 2012: 19). Current corporate governance issues are underpinned by larger problems of governance in democratic societies. However, corporations have remained extremely adaptable and efficient at responding to and changing in the general values of their context (Jackson & Carter, 1995: 883). In light of this, Table 2.7 illustrates the developments and approaches of corporate governance codes around the world.

TABLE 2.7: A brief overview of the developments and approaches undertaken by the UK, US, OECD and SA.

	UNITED KINGDOM	UNITED STATES	OECD	SOUTH AFRICA
ORIENTATION	Principles-based approach	Rules-based approach	Principles-based approach	Principles-based approach Hybrid model
LEGISLATURE	Voluntary	Compulsory	Voluntary	Voluntary
CODE	• Cadbury Report • Combined Code	• Sarbanes-Oxley Act • NYSE/NASDAQ • Dodd-Frank Act	• Principles of Corporate Governance	• King Code • Company Act

Source: *Conceptualised from Jesover & Kirkpatrick (2005: 128.)*

2.6 CORPORATE GOVERNANCE AND COMPANY PERFORMANCE

There is a continuing debate about the existence and correlation between good corporate governance and firm performance. A number of studies postulate that good governance processes create an environment that is conducive for economic success (Bebchuk, et al., 2009; Cremers & Nair, 2005; Gompers, Ishii, & Metrick, 2003; Yermack, 1996).

Du Plessis et al. (2010: 16) affirm that it does not follow that those who have good governance processes will perform the best or be immune against failure. However, by implementing good governance practices, managers have the opportunity to create significant shareholder value as well governed companies attract investors who are willing to pay a premium for shares and become a magnet for global capital (King Report, 2002: 23).

Durnev and Kim (2005) contend that firms that rely on external finance can use a reputation for effective governance to raise global equity and obtain debt at lower costs, which essentially increases a company's value by reducing its cost of capital and boosting investor confidence. Similarly, The OECD (2004) found that improved economic efficiency and better investor confidence were the result of good governance principles. By adopting good corporate governance practices, firms can:

- Increase the confidence of local investors
- Lower cost of capital
- Ensure the functioning of financial markets
- Introduce more stable sources of financing

The aim of this section is to perform a comprehensive review of the empirical literature on corporate governance variables and company financial performance. More specifically, it tracks the extant relationship between certain governance constructs and firm performance variables in order to position the hypothesis adopted in this study. The debate will begin with studies that have established corporate governance indices that have become representative of companies' adherence to specific governance standards. Following this is a discussion on performance measures utilised by various papers. The final section will argue how this study will contribute relevant and new data to extant research.

2.6.1 Composite corporate governance index in a developed economy

The most revered governance ranking study is that of Gompers et al. (2003). Gompers et al. (2003) utilised a composite governance index constructed on 24 rules to examine the link between governance and performance amongst 1500 US companies during 1990-1998. The results of the study suggest that an investment strategy that went long in corporations in the bottom most decile of the index and went short in companies in the highest decile would have earned abnormal returns of 8.5% per year during the sample period. Furthermore, Gompers et al. (2003) ascertained that companies with adequate shareholder rights had better firm values, increased profits, improved sales growth and lower capital expenses. The drawback of this study is that it is over ten years old. The governance implications that were investigated during that period may not be applicable today due to the rapidly changing landscape of the financial industry.

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The resultant effect of Gompers et al.'s (2003) pioneering study was a plethora of papers that utilised a governance index to determine the effect of corporate governance structures on performance. Cremers and Nair (2005) utilised Gompers et al.'s (2003) governance index to prove that US companies with better governance generate superior share returns and are valued higher by the market. More recent studies such as Brown and Caylor (2008) utilised a set of 51 factors from the Institutional Shareholder Services database to construct an alternative governance index. The study demonstrated the governance index had a stronger association with firm valuation (Tobin's Q) than the governance index developed by Gompers et al. (2003). Similarly, Shabbir and Padgett (2005) utilised 12 corporate governance provisions from the 1998 UK Combined Code to develop a non-compliance governance index for 122 listed firms from 2000-2003. Consistent with the results reported in previous studies, the index was positively related to total shareholder return, return on assets, and return on equity.

In slight contrast to the outcomes discovered, Bauer et al. (2003) used data based on information from Governance Metrics International to study the importance of governance for

Japanese firms. Share price, market value and operating performance were the three variables utilised to determine governance positively affects share price and company value, but exhibits a negative association with operating performance. One explanation for this negative association is that well-governed companies usually adopt prudent accounting policies that leads to conservative financial reporting.

The papers reviewed above demonstrate that most studies report a positive and significant relationship between governance and performance. It is important to emphasise that the evaluation of governance provisions is based on historic data with regard to the governance ranking studies. Moreover, it is challenging to find a universal consensus as certain codes vary, depending on the country and financial market. This is also true for businesses that operate within the same market and which are subject to the same regulation, but which have varying governance provisions that may impact performance. For example, companies operating in different sectors may face specific threats and opportunities. Furthermore, a weakness of governance ratings is that they are subjective assessments carried out by analysts, and are not usually direct examinations of a company's annual reports (Ntim, 2013: 7).

The result of this debate is that developing a consistent and comparable governance index is extremely difficult. Previous studies have failed to incorporate the distinctive institutional, cultural and contextual differences that exist in each country into corporate governance systems (Waweru, 2014: 457).

It is for this reason that this study will focus specifically on South Africa as it has distinctive aspects inherent within its financial culture and governance system that are not applicable to other countries. Additionally, it is advantageous to consider and incorporate these nuances in order to develop a governance index that is comprehensive, reliable and truly representative of South Africa's corporate governance system.

2.6.2 Corporate governance index in emerging economies

Black (2001) was among the first to explore the effect between the level of a composite governance index and financial performance in an emerging market context. The study examined 21 Russian firms based on a ranking established by a Russian Investment Bank in 1999, and found that there is a statistically significant positive correlation between governance and company value.

Following this, Klapper and Love (2002) utilised governance rankings constructed by Credit Lyonnais Securities Asia for 495 companies from 25 developing countries. The study demonstrates that well-governed companies have higher operating metrics and market

valuations. Furthermore, the positive relationship is more significant in countries that have poor legal systems. This implies that governance standards are more important in countries with poor legal systems and weak investor protection. Many country studies have used the same methodology employed in Klapper and Love's (2002) research study (Gupta, Kennedy, & Weaver, 2009; Garay & González, 2008; Beiner et al., 2006; Jang & Kim, 2006). Amongst these, Durnev and Kim (2005) echo the fact that companies with enhanced governance structures are rewarded by investors with higher market valuations, and its effect is more prominent in countries with inferior legal procedures.

Even though there have been several studies published that demonstrate the association between governance and performance in emerging economies, there is still a disproportionate number of papers that are concentrated in the US and Europe which have comparatively similar landscapes (Chen et al., 2010; Bebchuk et al., 2009; Bauer et al., 2003; Gompers et al., 2003).

Consequently, there is very little information about the correlation between corporate governance and company performance within South Africa. Although there has been a large amount of papers published in the field of business ethics in South Africa (Andreasson, 2009; Rossouw, 2009; Vaughn & Ryan, 2006; West, 2006; Rossouw et al., 2002), the impact of governance on corporate performance is relatively uncharted territory (Bhana, 2010: 1).

One of the few papers that explore this relationship within a South African context is that of Ntim (2013). Ntim (2013) assesses the association between an integrated governance index and financial performance based on 169 listed South African companies between 2002 and 2007. The index consists of 50 provisions based on the 2002 King Code. The study highlights that the South African corporate governance structure is a unique hybridisation of the traditional Anglo-American and European models, as it necessitates the compliance to black economic empowerment and employment equity provisions. This is specifically distinctive to South Africa, and by incorporating these constructs an index has been developed that is truly representative of the country's corporate governance system. By controlling for specific interdependencies such as block ownership, board size and leverage, the study finds a significant positive relationship between the corporate governance index and firm value. Ntim (2013) notes that future research should be developed to better control for possible interrelationship between other governance provisions and the value of a company.

This paper will attempt to control possible interrelationships by introducing three control variables namely sales growth, leverage and a dummy variable for time. Potential omitted variable bias and endogeneity can be significantly reduced by incorporating control variables into the analysis. This serves to ensure that the results are accurately represented and any

conclusions drawn are of a sound and credible basis. Moreover, although Ntim (2013) is a recently published paper, it is based on the provisions of King II. King III has since been introduced and adopted by South African corporates and as such will be incorporated into this study.

2.6.3 Specific corporate governance constructs

Previous studies have focused on particular facets of governance such as take-over defences (Gompers et al., 2003), executive compensation (Loderer & Martin, 1997), block holdings (Demsetz & Villalonga, 2001), ownership structures (Shleifer & Vishny, 1997) and board size (Yermack, 1996). One particular study conducted by Ntim and Kofi (2011) studied the impact of board meetings on performance for 169 listed companies in South Africa. The study revealed that there is a statistically significant and positive association between the frequency of board meetings and corporate performance.

Rushton (2008, p. 204) argues that concentrating on specific governance standards has superficial attractions. This research does not sufficiently encapsulate the advantages that may result from active ownership. On the other hand, research that is based on a governance ranking system may incorporate insignificant constructs that may distort the results. For this reason, valuable research should be based on a relatively small set of governance principles that can ascertain which variables are directly related to performance (Rushton, 2008, p. 205).

Although focusing on a small set of specific South African corporate governance standards has been highlighted as beneficial, there are some weaknesses to point out. Larcker and Tayan (2011) observe that case studies are able to address firm-specific questions, but their results are hard to generalise because they are based on a small amount of companies that may not be representative of the population. Furthermore, empirical findings can demonstrate relationships between variables, but cannot explain causality. The limited availability of data and issue of causation are issues that arise in the research into governance and performance.

2.6.4 Finding a consensus

Selvaggi and Upton (2008) tested the strength of any potential association between corporate governance and operating and share price returns. The study found a direct connection between governance and superior company performance. In contrast, Gill and Allen (2005) discovered well-governed companies do not outperform those which have weaker governance policies when economies are expanding, specifically when there is a surge in liquidity flows. There is a negative relationship between governance and performance. The research indicates that companies which have high levels of governance will only outperform less-governed companies when markets are bearish. There are alternate studies that have

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reported a negative association (Hutchinson, 2002; Bathala & Rao, 1995) or have not found any significant relationship (Park & Shin, 2004; Singh & Davidson, 2003). A consensus has yet to be reached and for this reason this study will attempt to provide some clarity on how corporate governance affects company performance.

The current study on governance in South Africa acknowledges the gap in the literature and attempts to address the weaknesses inherent in previous studies. The entire sample of 30 listed companies over a five-year period will be utilised, and unlike past cross-country studies (Durnev & Kim, 2005; Klapper & Love, 2002) will be able to ascertain the effects of both cross-sectional and time series changes in corporate governance on firm performance, as well as improve the generalisation of results. The construction of a governance index based on the provisions of King III enables the distinct characteristics of South Africa to be incorporated into the methodology.

Therefore, the respective null and alternate hypotheses to be tested in this study are that:

H_o: There is no significant relationship between the corporate governance index and company performance.

H_a: There is a significant relationship between the corporate governance index and company performance.

2.7 CONCLUSION

In summary, the five sections discussed thus far have:

- Highlighted that the definition of corporate governance has many different applications which may be interpreted in various ways.
- Investigated the theoretical frameworks of corporate governance in order to establish a solid theoretical foundation for the study.
- Presented the development and history within an international setting so as to underline the fact that it has become an important aspect of how companies operate.
- Introduced the South African case from which to analyse the aspects that make it unique and interesting.
- Explored a significant amount of extant studies in order to identify the gaps present within the literature.

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CHAPTER 3

RESEARCH DESIGN AND METHODOLOGY

3.1 INTRODUCTION

This section presents the research design followed for the empirical study conducted in this study. It describes the design, measurement of the main constructs introduced in the literature review, measurement instrument, the population, sample selection, sampling method, data collection and analysis. The research question attempts to determine if there is a significant relationship between corporate governance and company performance.

The objective of the research design is to choose a design which seeks to answer the research problem by fulfilling its constituent objectives, within the delimitations and expectations noted in Chapter 1, in order to generate findings that most accurately reflect reality. Mouton (2001: 109) stipulates that validity is a guide to 'achieving an approximation of the truth'. The success of the study is dependent upon the validity procedures undertaken at every phase of the research process. Table 3.1 outlines a validity framework, and this framework will form the basis on which the design is laid out in the remainder of the chapter.

TABLE 3.1: The validity framework

PHASE	SOURCES OF ERROR	METHODOLOGICAL STRATEGY	OUTCOME	VALIDITY QUALITY OR CRITERION
Conceptualisation	• Multifaceted ideas • Vagueness • Ambiguous constructs	• Comprehensive review of literature • Coherent definitions	Concepts	Theoretical validity
Measurement	• Instrumentation is outdated • Too simplistic • Unknown validity and reliability	• Construct validity • Content validity	Measuring instruments	Measurement validity
Sampling	• Bias • Heterogeneous populations	• Optimal sample size • Stratification	Sample	Representativeness
Data collection	• Capturing errors • Post-coding errors • Missing values	• Validation checks • Scanning	Data sets	Reliability
Analysis	• Competing explanations	• Suitable technique • Detailed interpretation of literature	Conclusion s/results findings	Inferential validity

Source: *Mouton (2001: 111)*

3.2 RESEARCH DESIGN

The dissertation will follow a descriptive research design with the aim being to obtain data that describes the characteristics of the subject at hand. Furthermore, this research report is classified as a longitudinal study because the data collected and analysed describes events over time. In order to collect and analyse the data, a panel was selected. Hair, Money, Page and Samouel (2003: 159) define a panel as a fixed sample prepared for the purpose of collecting data. Data collected will be quantitative and based on secondary sources.

In order to optimally address the objectives of the paper, the formulation of the research design in terms of measurement, instrument, sampling selection, data collection and analysis are symbiotic and were considered concurrently (Mouton, 1996: 110). The principal objective being to determine if company performance is affected by the implementation of the corporate governance framework adopted by companies listed on the JSE and defined in the sample.

3.2.1 Independent variable

The independent variable used in examining the relationship between the governance quality and performance in South Africa is a corporate governance index (CGI). This assumption is based on previous studies, namely those of Brown and Caylor (2004); Klapper and Love (2002); Ntim (2013) and Durnev and Kim (2005). It is therefore not necessary to test for causality to confirm that the corporate governance index is the independent variable. For the purpose of this research, a corporate governance index will be constructed as no such index is currently available within the South African economy. The CGI will be based on the aggregation of 10 comprehensive provisions contained in the 2009 King Report. These provisions will be discussed in the subsequent section. They are categorised into four parts namely:

1. Boards, directors and ownership
2. Accounting and auditing
3. Risk management, internal audit and control
4. Integrated sustainability reporting

The corporate governance index is unlike corporate governance variables, utilised in previous research. It covers almost all aspects of corporate governance whereas previous studies focus on isolated aspects only. Significant among these variables are: Takeover defences (Gompers et al., 2003), executive compensation (Loderer & Martin, 1997), block holdings (Demsetz & Villalonga, 2001), board size (Yermack, 1996) and board composition (Bhagat & Black, 2001).

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The incorporation of a host of corporate governance mechanisms allows for the interrogation of potential interactions and interdependences amongst alternative provisions. Furthermore, the index incorporates provisions that are characteristically South African, such as employment equity and black economic empowerment.

It can be argued that direct comparisons with prior studies may be invalid if South African context-specific characteristics in the index are incorporated. However, South African issues account for 10% (1 out of 10) of the index. Therefore, the South African corporate governance index is dominated by conventional governance provisions, but still has the potential to uncover valuable insights that could enrich the current literature pool.

3.2.2 Dependent variables

The dependent variable is company performance. Two measurements namely the return on assets (ROA) and Tobin's Q are utilised as proxies for accounting and market-based measures of financial performance respectively. This is in line with previous research (Gompers et al., 2003; Klapper & Love, 2002). The accounting-based measure of performance (ROA) captures the performance of management and is not influenced by the differential degree of leverage present within companies. The market-based measure (Tobin's Q) is representative of the financial valuation of corporate governance structures by investors. Table 3.2 lists the characteristics of each measure.

TABLE 3.2: Overview of ROA and Tobin's Q

	ROA	**TOBIN'S Q**
CALCULATION	$\frac{\text{Book value of operating profit}}{\text{Book value of total assets}}$	$\frac{\text{Market value of equity+ Book value of total assets- Book value of equity}}{\text{Book value of total assets}}$
DEFINITION	How well a company runs its operations and uses assets to produce revenue.	Proxy for markets' valuation of the quality of a firm's corporate governance structures
BENEFIT	Reflect year-to-year fluctuations in business conditions	Empirical validity is supported by thoroughly investigated empirical research
DISADVANTAGE	• Past profits are a poor reflections of future profitability • Susceptible to managerial manipulations	• Spurious correlations with corporate governance mechanisms • Expensive in terms of computational effort

Source: *Chung and Pruitt (1994: 70); Gompers et al. (2003); Hassan and Marston (2010: 23)*

Control variables were introduced to reduce potential omitted variable bias and endogeneity. Ntim (2013: 152) stipulates that the omission of significant economic variables that predict company performance within a corporate governance context could lead to the misrepresentation of results. For this reason, two specific control variables were chosen namely:

- Growth potential variable

The growth potential variable represents year-on-year sales growth. Durnev and Kim (2005: 1473) contend that companies that have ample investment opportunities tend to develop relatively faster. This exponential growth can lead to companies receiving higher valuations, which is based on the premise of improved future performance (Klapper & Love, 2004: 712).

- Leverage variable

A company's leverage is the ratio of total debt to the market value of equity. Jensen and Meckling (1976: 323) specifies that increased gearing can enhance performance by decreasing agency disputes which arise with availability of free cash flows and opportunistic managers.

3.2.4 Model specification

The first regression model will examine Tobin's Q against the governance scores and selected control variables. The following equation will be used in the ordinary least squares (OLS) regression model:

$$\text{Tobin's Q} = \propto_i + B_1 CGI_{it} + B_2 SalesGrowth_{it} + B_3 Leverage_{it}$$

The second regression model regresses ROA against the governance index and the same control variables. The following equation is used:

$$ROA = \propto_i + B_1 CGI_{1it} + B_2 SalesGrowth_{it} + B_3 Leverage_{it}$$

The company effect $\propto_i$ is taken to be constant over time t and particular to the firm's cross-sectional unit i. There are two basic frameworks used to generalise this model. The fixed effects approach takes $\propto_i$ to be a firm specific constant term in the regression model. The random effects approach specifies that $\propto_i$ is a firm specific disturbance. The Hausman test will be run in order to determine which model is more efficient.

3.3 MEASURING INSTRUMENTS

The next step in the research process is the construction of an appropriate measuring instrument in order to test concepts (Mouton, 2001: 66).

TABLE 3.3: Measurement validity framework

STAGE IN RESEARCH PROCESS	SOURCES OF ERROR	METHODOLOGICAL STRATEGY	OUTCOME	VALIDITY QUALITY OR CRITERION
Measurement	• Instrumentation is outdated • Too simplistic • Validity and reliability is unknown	• Construct validity • Content validity	Measuring instruments	Measurement validity

Source: *Mouton (2001: 111)*

A simple binary coding scheme was adopted in order to construct the corporate governance index which is utilised based on previous research (Ntim & Kofi, 2011; Bauer et al., 2003; Gompers et al., 2003;)**.** The index is created by granting a value of '1' for each of the 10 governance provisions of King III that are reported in the annual financial statements, or '0' if otherwise. A company's total score within a specific year can vary between zero (0%) and ten (100%) with better governed firms having higher index levels. Table 3.4 highlights objections to and reasons for the adoption of simple binary weighting scheme.

TABLE 3.4: Objections and reasons for adopting a simple binary weighting scheme

OBJECTIONS	REASONS FOR ADOPTION
• Fails to incorporate the relative importance of various governance provisions (Gompers et al., 2003) • Too simplistic	• There is no theoretical basis on which weights can accurately be allocated to the various governance provisions • Transparent and easy to replicate • Efficient implementation of the line of scoring information reported in the reports

Source*: Gompers et al.,(2003); Hassan and Marston (2010)*

For this study, the simple binary approach was chosen because it is easily simulated and efficiently captures important information in a simplified way. Caution should be exercised as it does not incorporate the relative significance of governance provisions.

3.3.1 Questions included in the governance index

Table 3.5 presents the 10 various questions that were incorporated into the governance index based on the provisions of King III and the subsequent reasoning for their selection.

Table 3.5: The governance provisions of the index and reasoning for inclusion.

PROVISION	REASON FOR SELECTION
Is there evidence that the company complies with the King Code and has not received any adverse publicity regarding its corporate governance policies?	The first and foremost question to be considered is that the company has stated that it complies with the King Code. Furthermore it is important to check numerous news sources as any undesirable behaviour conducted by the company will not be disclosed in the financial statements.
Is there evidence that supports that the board has been fulfilling its responsibilities and has not acted negligently?	At the most fundamental level of governance is the board which should act in the best interests of the stakeholders and fulfilling their stated obligations.
Are the roles of chairman and CEO split?	This is a principal provision of King III.
Is the chair person an independent non-executive director (NED)?	The independence of the chairman is vital to ensuring that objective decisions and unbiased judgements are made.
Has a remuneration committee been established?	The implementation of a remuneration council demonstrates that a company is committed to rational compensation policies for the board.
Is there evidence that executive remuneration is not excessive or reckless?	The disclosure of the executives' compensations for sitting on the board was carefully scrutinised for any irregularities that may have been prevalent.
Is there evidence that the company is enforcing broad based black economic empowerment and empowerment of women laws?	This is a provision that is specifically unique to South Africa and the King Code and brings in a contextual dynamic.
Is the audit committee comprised of at least two independent NEDs with substantial professional financial training and expertise?	The independence of an audit committee means that the resulting annual financial statements will be a reliable and honest representation of the company's financial position.
Is there a policy that prohibits directors and employees from share dealings around the release of price sensitive information?	Insider trading and market manipulation are illegal activities that are punishable offences.
Is there sufficient disclosure of external and internal control systems that can effectively compute, evaluate and control the company's competitive positioning, operating performance and risk management capabilities?	It is important for a company to communicate to its stakeholders the extent to which it is monitoring the risk inherent within its sector. This shows that the company is actively looking for ways to better position and improve their profitability.

Source: *Researcher's own construct*

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3.4 SAMPLING

Sampling follows the measurement stage in the research process. Sampling is a valuable alternative to collecting data from an entire population as it is of a manageable size (Saunders et al., 2011: 260).

TABLE 3.6: Sampling validity framework

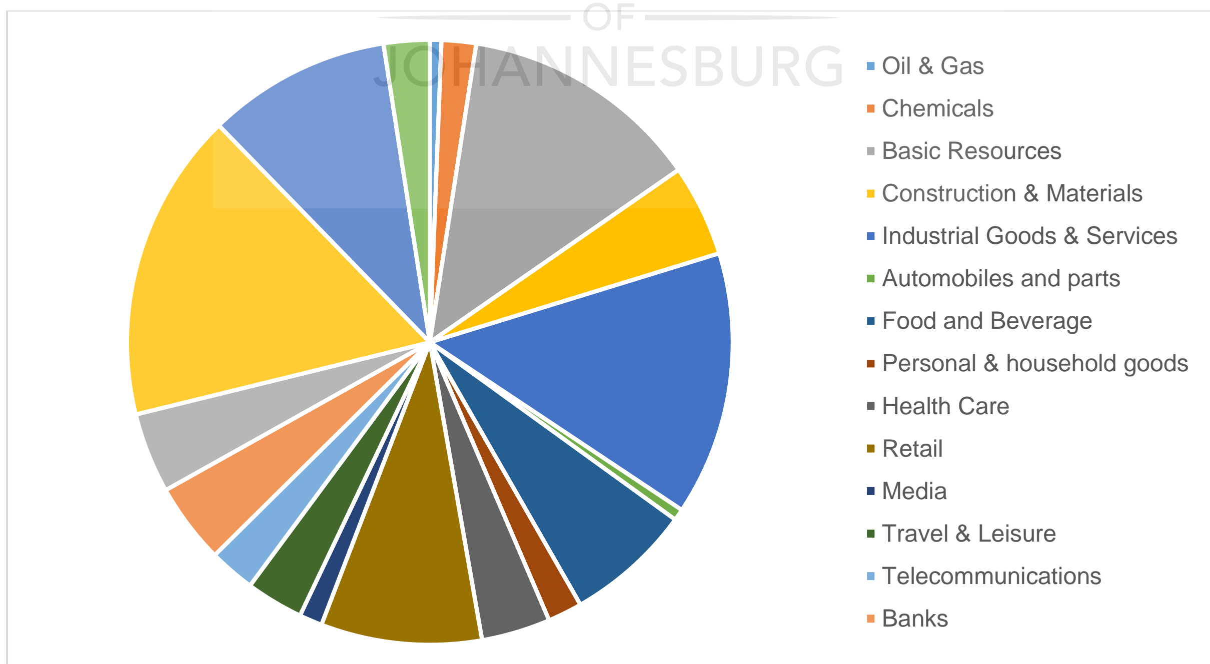
STAGE IN RESEARCH PROCESS	SOURCES OF ERROR	METHODOLOGICAL STRATEGY	OUTCOME	VALIDITY QUALITY OR CRITERION
Sampling	• Bias • Heterogeneous populations	• Optimal sample size • Stratification	Sample	Representativeness

Source: *Mouton (2001: 111)*

3.4.1 Target population

The target population comprises of all companies listed on the All Share Index as it is highly representative of the total population of shares listed on the JSE. Figure 3.1 depicts the industrial composition of companies within the All Share Index. The FTSE/JSE All Share Index represents 99% of the full market capital value of all ordinary securities on the main board of the JSE (JSE, 2014).

Figure 3.1: Supersector breakdown of the target population based on the number of constituents in the All Share Index



Source: (JSE, 2014)

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3.4.2 Sampling method

Non-probability convenience sampling was used as the sampling method. Convenience sampling was considered as the most suitable sampling methodology, as a specific segment of the population was targeted, namely 30 companies listed within the FTSE/JSE All Share Index. Convenience sampling ensures that samples are easily obtainable and the associated costs are low. However results utilising this particular method are not easily generalisable (Leedy and Ormrod, 2013: 214).

3.4.3 Sample

Out of the population, a sample consisting of 30 listed companies on the JSE was selected. The basis for the selection of the sample is that these companies' market values make up over 85% of the JSE's total market capitalisation as of the 31st December 2014. The reason why this sample will be sufficient is that the companies selected have some of the highest market capitalisation levels on the JSE, and as such epitomise a broad range of stakeholders' interests and shareholders' wealth in South Africa. The results from this sample will be adequate from which to draw inferences about the entire population, as the companies selected are sufficiently diversified and represent numerous sectors of the JSE. The data collected are for a 5-year period from 2009 to 2013. In total there are 150 data points considered within the panel regression, which was deemed robust and significantly representative to produce reliable results.

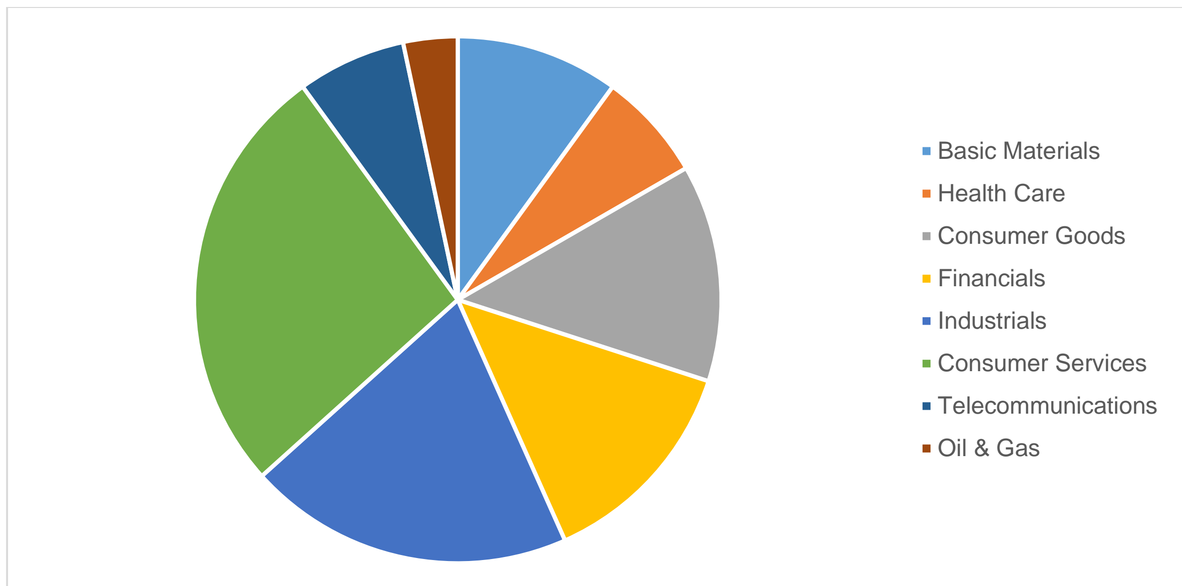
In order to develop a representative sample of companies within the All Share Index the companies in the sample had to meet three criteria namely:

1. The availability of a company's full 5-year reports from 2009 to 2013.
2. The availability of financial data from 2009 to 2013.
3. In compliance with the provisions of the King Code.

These criteria were imposed in order to meet the requirements of a balanced panel data analysis. Furthermore, in contrast to the existing literature that utilise one-year cross-sectional data (Durnev & Kim, 2005; Klapper & Love, 2004), this study utilises data from 2009 to 2013 with both cross-sectional and time series properties which may aid in ascertaining whether the relationship between firm performance and corporate governance holds over time.

Figure 3.2 presents the industrial composition of listed firms that meet the criteria and were sampled. 60% of the sample is made up of constituents from four industries namely consumer services, financials, industrials and consumer goods.

FIGURE 3.2: Industrial composition of sampled firms based of the number of constituents selected



Source: *Standard Bank Online Trading (2014)*

3.5 DATA COLLECTION

The collection of data is the penultimate step within the research process. Table 3.7 refers to the data collection validity framework.

TABLE 3.7: Data collection validity framework

STAGE IN RESEARCH PROCESS	SOURCES OF ERROR	METHODOLOGICAL STRATEGY	OUTCOME	VALIDITY QUALITY OR CRITERION
Data collection	• Capturing errors • Post-coding errors • Missing values	• Validation checks • Scanning	Data sets	Reliability

Source: *Mouton (2001: 111)*

The data was collected from the annual reports of the 30 specified companies. In order to ensure consistency of reporting, the annual reports were obtained from a single source namely Standard Bank's Online Share Trading website. Ntim (2013) argues that annual reports are a regular and reliable source of information, as the Companies Act and JSE Listings Rules mandate companies to issue fully audited and independently verified annual reports. In addition, using company annual reports as a source is in line with prior studies allowing for direct comparison (Shabbir and Padgett, 2005; Yermack, 1996).

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3.6 DATA ANALYSIS

Data analysis is the final stage of the research process. Table 3.8 demonstrates the aspects of the analysis and interpretation validity framework.

TABLE 3.8: Analysis and interpretation of validity framework

STAGE IN RESEARCH PROCESS	SOURCES OF ERROR	METHODOLOGICAL STRATEGY	OUTCOME	VALIDITY QUALITY OR CRITERION
Analysis	• Competing explanations	• Suitable technique • Detailed interpretation of literature	Conclusions/ findings	Inferential validity

Source: *Mouton (2001, p. 111)*

A significant implication of this objective was the identification of a suitable data analysis technique which would determine if the relationship between the South African corporate governance index and company financial performance is significant. Therefore, a key deciding factor together with the study's objectives was the selection of elements that are inherent within the research design.

3.6.1 Panel data analysis

Panel data estimation is considered to be an efficient analytical method in handling econometric data (Asteriou & Hall, 2007: 344). A panel data set follows a selected sample of variables over time and as such delivers numerous observations on each variable in the sample (Hsiao, 2003: 1). Baltagi (2008: 6) lists the following benefits of panel data analysis:

- Controls for individual heterogeneity. Panel data assumes that individuals, companies and countries are heterogeneous. Contrastingly, time-series and cross-sectional studies that fail to control for heterogeneity, may lead to biased results.
- Gives more informative data, more variability, less collinearity among variables, more degrees of freedom and more efficiency. Longitudinal data allows a researcher to analyse a number of important economic questions that cannot be addressed using cross-sectional or time-series data sets.
- Better able to examine the dynamics of adjustment. Unlike cross-sectional studies, panel surveys generate information on changes for companies. It allows the researcher to observe variations in company performance during the specified period.

- Better able to identify and measure effects that are not detectable in pure cross-section and time-series data.
- Ability to construct and test more complicated behavioural models than purely cross section or time-series data.

One of the requirements of panel data analysis is the use of quantitative data which is in accordance with investigations of causal or correlational associations between variables (Ponterotto, 2005: 128). Quantitative methods were employed to examine the relationship between the independent and dependent variables. Therefore, based on the selection of panel data analysis as the principal analysis technique and its need for quantitative data, secondary data-based research appears to best meet the criteria of panel data analysis. Secondary data analysis allows a certain amount of longitudinal analysis with relative ease.

The use of a secondary data analysis strategy allows for the development of a structured corporate governance index which involves the aggregation of 10 corporate governance provisions contained in King III. Secondary data analysis provides the opportunity to obtain standardised primary quantitative data which can be readily compared and analysed using descriptive and inferential statistics (Mouton, 2011: 153; Saunders et al., 2012: 134). Table 3.9 highlights the benefits and restrictions of secondary data analysis.

TABLE 3.9: Strengths and limitations of secondary data analysis

STRENGTHS OF SECONDARY RESEARCH	LIMITATIONS AND ERRORS OF SECONDARY RESEARCH
• Fewer resources requirements • Transparent research method whereby the coding scheme and sampling procedures can be clearly explained so that replication and follow up studies are feasible • High quality data • Not obtrusive • Feasibility of longitudinal studies • Provide relative and circumstantial data • Result in unpredicted findings • Permanence of data	• Collected for a purpose that doesn't match the researcher's need • Only as good as the documents from which the variables are analysed • Absence of key variables • Problems arise when aim is to impute latent rather than manifest content • Access costly and challenging • Definitions may be inappropriate • No control over quality of data

Source: *Saunders et al. (2012: 318-320) and Bryman and Bell (2007: 318-321)*

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3.7 DESIGN LIMITATIONS

The following list will highlight several limitations of the applicable research design.

- Distortions of measurement errors. This may arise as unclear questions may illicit the capturing of faulty answers. This will be addressed by ensuring that the index has clear and unambiguous questions that can easily be answered and understood in the financial statements.
- Short time-series dimension. Typical panels incorporate annual data covering a short span of time for each company. This is true as this study incorporates data over a 5-year period which was considered sufficient for the scope of this minor dissertation.
- Heterogeneity bias. Statistical heterogeneity will be addressed by the fixed and random effects model.

3.8 ETHICAL PROCEDURES

A code of ethics was developed to ensure that the highest ethical standards were maintained by the researcher. Table 3.10 encapsulates this code of ethics.

TABLE 3.10: Ethical principles

ETHICAL PRINCIPLE	RATIONALE FOR IMPLEMENTATION OF PRINCIPLE
Integrity of the researcher	The quality of the research is dependent upon the integrity of the researcher. This entails being honest and accurate and avoiding misrepresentation of data and findings.
Ensuring the reliability of the analysis and reporting of findings are accurate.	The collection of the data should be honest and should not be made up or falsified. The reporting of findings should be presented accurately regardless of whether they fulfil the expected outcomes.
Maintenance of objectivity	Researchers should strive to uphold objectivity in the treatment of findings and results. Researchers should clearly communicate all research limitations.

Source: *Saunders et al. (2011, p. 231)*

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3.9 CONCLUSION

The aim of this chapter was to explain and validate the methodology used for the empirical research phase. This is keeping with the principal aim of the paper namely to investigate if there is a significant relationship between corporate governance and company performance. In order to achieve this, a corporate governance index will be constructed by assessing the financial statements of 30 listed South African companies over a 5 year period. The index will be regressed against two performance measures namely the ROA ratio and Tobin's Q. The regression analysis will be based on a panel design which has the advantage of being able to control for individual heterogeneity. Throughout this study the ethical principles mentioned in table 3.10 will be adhered to so as to ensure that it is accurate and objective. The next chapter reports on the results of the panel data analysis.

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CHAPTER 4

EMPIRICAL ANALYSIS AND INTERPRETATION OF RESULTS

4.1 INTRODUCTION

This chapter analyses and documents the empirical findings of the study. It presents the statistical treatment, analysis and interpretation of the data collected from the empirical study. Furthermore, it integrates the empirical research with the research findings obtained from the literature in relation to specific objectives. In the first section the descriptive statistics of each variable are presented and interpreted. Following this, a correlation matrix is depicted in order to explore the relationship between each variable and to determine whether any of the variables are highly correlated. The final section exhibits the results of the panel regression for Tobin's Q and the ROA ratio in relation to the corporate governance index.

4.2 PRESENTATION AND INTEPRETATION OF THE RESULTS

4.2.1 Descriptive analysis

Table 4.1 presents a summary of the descriptive statistics of all variables incorporated into the study for the entire sample over the period 2009-2013.

TABLE 4.1: Descriptive statistics of all variables

	ROA	Tobin's Q	CGI	DE	Sales Growth	Total Assets
Mean	10.80	2.04	0.76	0.70	0.12	90849
Median	9.18	1.67	0.80	0.38	0.11	17923
Maximum	56.56	6.20	1.00	11.44	1.77	1381648
Minimum	-24.76	0.67	0.10	0.00	-0.32	732
Standard deviation	9.16	1.18	0.17	1.28	0.23	194803

Abbreviations: **DE** = Debt to equity ratio, **ROA** = Return on assets ratio, **CGI** = Corporate governance index

- The corporate governance index varied from 10% to 100%. The average corporate governance score over 30 companies was 76%, which indicates that there is a relatively high compliance rate to the corporate governance provisions stipulated in the index. The relative variance in the reported minimum and maximum figures also suggests that the CGI is adequately selected to reach a sufficiently comprehensive distribution. There is a high degree of heterogeneity that is prevalent in the sample with regard to the significance that South African companies attach to corporate governance standards. Furthermore, this goes to show that even though the King code is voluntary, South African companies realise its significance and have chosen to adopt the stipulated provisions.
- Tobin's Q was between a maximum of 6.20 and a minimum of 0.67. The average Tobin's Q was 2.04. This implies that there is extensive variation in the market valuations of the selected companies.
- The control variables also showed a wide variation in their minimum and maximum figures. This suggests that the sampled companies have been adequately selected and thus reduce the possibility of sample selection bias that has been an issue in previous studies (Durnev & Kim, 2005; Klapper & Love, 2004).

4.2.2 Correlation Matrix

Table 4.2 depicts the correlation matrix of all the variables.

TABLE 4.2: Correlation matrix of all variables

	ROA	Tobin's Q	CGI	DE	Sales Growth	Total Assets
ROA	1.00	0.64	-0.01	-0.20	0.03	-0.08
Tobin's Q	0.64	1.00	-0.01	-0.1	0.00	-0.14
CGI	-0.01	-0.1	1.00	0.12	-0.11	0.1
DE	-0.20	-0.1	0.12	1.00	0.03	-0.08
Sales Growth	0.03	0.00	-0.11	0.03	1.00	-0.06
Total Assets	-0.08	-0.14	0.01	-0.08	-0.06	1.00

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Apart from the high correlation (0.64) among Tobin's Q and ROA, the correlations among the variables are relatively low. The analysis of the correlation between the variables is important to test for the presence of multicollinearity. This indicates that no major multicollinearity problems are prevalent.

4.2.3 Panel Data Regression Analysis

The next section will present the results of the panel data analysis for each dependent variable, namely the ROA ratio and Tobin's Q. Each dependant variable will be tested against the independent and control variables utilising the following models and tests:

1. Ordinary least squares (OLS) model
2. Hausman test (1978)
3. Random effects model

4.2.3.1 ROA

The following Table reports the results from the panel regression using the OLS model for the ROA ratio on the CGI, along with the control variables. The control variables are introduced to reduce omitted variable bias. The results of the OLS model indicate that the CGI is not statistically significant (0.73). The Hausman test (1978) was performed in order to determine whether the fixed effect or random effects model was more efficient. Furthermore firm heterogeneity that is not captured by the control variables could correlate with the ROA ratio and the CGI and alter the results. The Hausman test (1978) determined that the random effects model was better suited as insignificant p-values were observed (0.82).

TABLE 4.3: Results of OLS regression

N=30	R^2= 0.05 Adj R^2= 0.03 F-Stat= 1.98 P= 0.10			
Variable	**Coefficient**	**Std. Error**	**t-Stat**	**Prob.**
Intercept	10.97	3.49	3.14	0.00
CGI	1.50	4.45	0.34	0.74
DE	-1.52	0.59	-2.59	0.01
Sales Growth	1.49	3.29	0.45	0.65
Total Assets	-4.73	3.84	-1.23	0.22

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The random effects model's results echoed those of the OLS model whereby the CGI is not statistically significant (0.74) as depicted in Table 4.4. These results indicate that corporate governance does not have a significant effect on financial performance as measured by the ROA. These same findings are observed in studies carried out by Park and Shin (2004) and Singh and Davidson (2003). This evidence does not offer empirical support to prior studies (Durnev & Kim, 2005; Brown & Caylor, 2004; Klapper & Love, 2004) that report a statistically significant relationship between the ROA ratio and governance. There are two plausible explanations for this insignificant finding. Firstly, accounting measures are subject to manipulation. Secondly, the ROA is based on historical costs which may not be able to adequately capture current changes in market valuation.

TABLE 4.4: Results of random effects regression

N=30	R^2= 0.59 Adj R^2= 0.47 F-Stat= 5.03 P= 0.00			
Variable	**Coefficient**	**Std. Error**	**t-Stat**	**Prob.**
Intercept	10.23	4.05	2.53	0.01
CGI	1.89	4.92	0.38	0.70
DE	-0.94	0.73	-1.28	0.20
Sales Growth	2.54	2.64	0.96	0.34
Total Assets	-5.87	5.62	-1.04	0.30

4.2.3.2 Tobin's Q

Table 4.5 depicts the outcomes of the OLS model for Tobin's Q. The model shows that the CGI is not statistically significant (0.83). As reported, the random effects model was verified to be more aptly suited by carrying out the Hausman test (1978), which was insignificant at (0.54).

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TABLE 4.5: Results of OLS regression

N=30	R^2= 0.03 Adj R^2= 0.00 F-Stat= 3.98 P= 0.00			
Variable	**Coefficient**	**Std. Error**	**t-Stat**	**Prob.**
Intercept	2.10	0.43	4.86	0.00
CGI	0.12	0.55	0.21	0.83
DE	-0.10	0.07	-1.31	0.19
Sales Growth	-0.00	0.41	-0.02	0.99
Total Assets	-8.41	4.7	-1.78	0.08

TABLE 4.6: Results of random effects model

N=30	R^2= 0.84 Adj R^2= 0.80 F-Stat= 17.94 P= 0.00			
Variable	**Coefficient**	**Std. Error**	**t-Stat**	**Prob.**
C	0.75	0.35	2.13	0.03
CGI	1.80	0.44	4.05	0.00
DE	-0.02	0.07	-0.28	0.78
Sales Growth	0.07	0.20	0.33	0.75
Total Assets	-8.54	6.97	-1.22	0.22

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In contrast to the findings reported, Table 4.6 shows that the CGI index is statistically significant (0.00) and positive (1.80) at the 1% level. The adjusted R^2 of the model is 0.80 and the F-value of 17.93 is significant at the 1% level (0.00). The adjusted R^2 indicates that the model explains 80% of the variation in the Tobin's Q. The hypothesis that there is no significant relationship between firm performance and the quality of corporate governance is therefore rejected. The random effects model demonstrates that corporate governance does have an effect on firm performance in terms of Tobin's Q, which is an important measure of a company's market value in many financial interactions.

Although consistent results were not reached in terms of the ROA ratio, the findings, in terms of the Tobin's Q ratio, do contribute to the growing body of literature that suggests there is a positive relationship (Ntim, 2013; Durnev & Kim, 2005; Brown & Caylor, 2004; Klapper & Love, 2004). The findings imply that better corporate governance practices are reflected in statistically significant higher market values. These findings have the following implications for the study:

- Companies which incorporate good governance principles are positively signalling prospective investors.
- This implies that South Africa investors are willing to pay a premium for better governed companies.
- The positive effects of corporate governance that result in higher valuations are explained by the increase in investor confidence.
- Investors will be more willing to provide capital at a lower cost.
- The impact of this is that the costs of implementing governance procedures do not outweigh the monitoring benefits.
- Debt and equity should flow to those companies capable of investing it in the most effective way.

4.3 Controlling shareholders will have fewer means to expropriate company cash flows. CONCLUSION

This section has presented and interpreted the findings of the panel data analysis. The descriptive statistics showed that on average, South African companies adhere to a high level of corporate governance. Furthermore, the correlation matrix indicated that there was no significant multicollinearity among the variables. The regression analysis concluded that there was no significant relationship between ROA and the index. However, there was a statistically significant and positive relationship between Tobin's Q and the index. Based on this finding, the null hypothesis can be rejected. The final section will succinctly summarise the key points and findings of the study. It will also identify the limitations of this study and make recommendations for future research.

CHAPTER 5

CONCLUSION

The main purpose of this study was to investigate the relationship between corporate governance and company financial performance. Chapter One provided an introductory background and context to the research problem. It highlighted that the pervasiveness of corporate governance has been aided by the structural challenges faced by large multinationals. These structural problems present themselves in various ways and are most commonly in the form of fraud, accounting misrepresentations, reckless excessive director reimbursements, and other organisational failures. These occurrences have also been compounded by the spread of capitalism, the growth of the corporate sector and globalisation. Furthermore, it is argued that better insights into the antecedents of effective corporate governance mechanisms will be instrumental in determining how South African companies can efficiently improve performance by implementing effective governance structures.

Following this, Chapter Two was broken down into five separate sections whereby extant literature was constructively and critically analysed in order to place the current research report within a wider body of knowledge. The first section provided a working definition of corporate governance by chronologically interrogating significant sources. A single working definition underpinned the dialogue about corporate governance and allowed the reader to better appreciate the correlation between governance and company performance. The second section detailed the theoretical underpinnings of the discipline, which is rife with debate over the shareholder and stakeholder model. The third section discussed the development of governance on a global scale, which established the validity of the South African King Reports. The fourth section presented the progression of governance regulation within South Africa. South Africa presents a fascinating case from which to research, as local companies compete in the context of tough economic conditions, growing socio-political tensions, and an increasing dependence on foreign capital inflows to keep the economy afloat. The final section identified numerous studies that have explored the relationship between corporate governance and firm performance. This to acknowledge strengths that complemented the applicable study, whilst also identifying limitations that were improved upon.

Chapter Three presented the research design adopted for the empirical study in order to answer the research question at hand. A corporate governance index was developed, based on the aggregation of 10 provisions that incorporated the contextual aspects of South Africa and the King III principles. The compilation of the index was based on a sample of 30 South

African companies listed on the JSE over a period of five years from 2009-2013 and is the first of its kind in South Africa. The index was regressed against two performance measures namely the ROA ratio and Tobin's Q. Furthermore, two control variables were introduced to reduce potential omitted variable basis. The data was analysed by utilising panel data analysis. This was beneficial as it assumed that the companies considered were heterogenous. The adherence to the highest ethical principles was stipulated in order to uphold the integrity of the research.

Chapter Four presented the statistical treatment, analysis and interpretation of the data collected from the empirical study. The varying outcomes of the descriptive statistics indicate that on average, South African companies uphold a high level of compliance in terms of corporate governance standards. These results confirm that South Africa has a well-established corporate governance code in the form of the King Reports and if it continues to pursue these sophisticated measures, this will ensure that it holds its place as a prominent and desirable emerging market destination for international and local investors.

The results of the panel data analysis revealed that there was no significant relationship between the CGI and the ROA ratio. However, there was a statistically significant and positive association between Tobin's Q and the index. On this basis, it is possible to reject the null hypothesis that there is no significant relationship between corporate governance and firm performance. Although consistent results were not reached in terms of the ROA ratio, the findings, in terms of the Tobin's Q ratio, do contribute to the growing body of literature that suggests there is a positive relationship (Ntim, 2013; Durnev & Kim, 2005; Brown & Caylor, 2004; Klapper & Love, 2004).

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These results have several important implications for South African companies and the country's economy:

- Strengthening the confidence of investors through an effective governance regime will increase the long-term competitiveness of corporations, and is beneficial to the overall health of the economy.
- The emergence of truly independent directors, who act not for a particular stakeholder but for the collective interest of all stakeholders, means that companies become more transparent.
- As an emerging economy, the implementation of good corporate governance standards may not only help reduce the risk of corporate collapses, but may also encourage foreign direct investments within the country.

Ultimately, there is potential for significant benefits to growth and broader socio-economic issues. Good governance stimulates the effective division of labour, improved productivity of

investment, and efficient implementation of social and economic policies which are all significant drivers of sustained economic growth (Gibbs, 2014, p. 3).

Even though the results are robust to endogeneity, accounting and market-based firm value proxies and unobserved firm-level heterogeneity, the evidence should be interpreted in light of the following:

- The sample consists of 30 of some of the largest companies listed on the JSE which means that the results cannot be generalised to other smaller and privatised firms operating within South Africa.
- This study is limited to companies in South Africa. For this reason, companies operating in other developing countries may differ from South Africa. This may also be because of legal and regulatory constraints and economic policies that may differ between countries.

Future research may be enhanced by:

- Considering a greater volume of data and including more provisions in the corporate governance index to improve the reliability and accuracy of the findings.
- Extending the research to include a longer dated time series.
- Building a model that can facilitate the comparison of findings that relate to companies in other countries, whether it be in developing or developed nations.

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APPENDIX A

Full list of the South African Corporate Governance Index Provisions Based on King III

	2013	2012	2011	2010
1. Is there evidence that the company complies with the King Code and has not received any adverse publicity regarding its corporate governance policies?				
2. Is there evidence that supports that the board has been fulfilling its responsibilities and has not acted negligently?				
3. Are the roles of chairman and CEO split?				
4. Is the chairperson an independent non-executive director?				
5. Has a remuneration committee been established?				
6. Is there evidence that executive remuneration is not excessive or reckless?				
7. Is there evidence that the company is enforcing broad-based black economic empowerment and empowerment of women laws?				
8. Is the audit committee comprised of at least two independent NEDs with substantial professional financial training and expertise?				
9. Is a policy that prohibits directors, officers and employees from share dealings around the release of price sensitive information?				
10. Is there sufficient disclosure of external and internal control systems that can successfully calculate, evaluate and control competitive positioning, operating performance and risk management capabilities?				

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APPENDIX B

An overview of the King III Principles

GOVERNANCE ELEMENT	PRINCIPLES
1. Ethical leadership and corporate citizenship	The board should: 1.1. provide effective leadership based on an ethical foundation. 1.2. ensure that the company is and is seen to be a responsible corporate citizen. 1.3. ensure that the company's ethics are managed effectively.
2. Boards and directors	The board should: 2.1. act as a focal point for and custodian of corporate governance. 2.2. appreciate that strategy, risk, performance and sustainability are inseparable. 2.3. provide effective leadership based on an ethical foundation. 2.4. act in the best interests of the company. 2.5. consider business rescue proceedings or other turnaround mechanisms as soon as the company is financially distressed as defined in the New Companies Act. 2.6. elect a chairman of the board who is an independent non-executive director. The CEO of the company should not also fulfil the role of chairman of the board. 2.7. appoint a chief executive officer and establish a framework for the delegation of authority. 2.8. comprise a balance of power with a majority of non-executive directors. The majority of non-executive directors should be independent. 2.9. delegate certain functions to well-structured committees but without abdicating its own responsibilities. 2.10. appoint directors through a formal process. 2.11. conduct ongoing training and development of directors through formal processes. 2.12. be assisted by a competent, suitably qualified and experienced company secretary. 2.13. evaluate the board, its committees and the individual directors annually. 2.14. agree on a governance framework that suits the group and its subsidiary boards. 2.15. remunerate directors and executives fairly and responsibly. 2.16. disclose the remuneration of each individual director and certain senior executives. 2.17. approve the company's remuneration policy.
3. Audit committees	3.1. The board should ensure that the company has an effective and independent audit committee.

	3.2. The audit committee members should be suitably skilled and experienced independent non-executive directors. The audit committee should: 3.3. be chaired by an independent non-executive director elected by the board. 3.4. oversee integrated reporting. 3.5. be an integral component of the risk management process. 3.6. report to the board and shareholders on how it has discharged its duties. 3.7. be responsible for recommending the appointment of the external auditor and overseeing the external audit process.
4. The governance of risk	The board should: 4.1. be responsible for the governance or risk and must have a policy and plan for a system and process of risk management. 4.2. delegate to management the responsibility to design, implement and monitor the risk management plan. 4.3. ensure that the risk assessments are performed on a continual basis. 4.4. ensure that the frameworks and methodologies are implemented to increase the probability of anticipating unpredictable risks and the board should ensure that a framework and processes are in place to anticipate unpredictable risks. 4.5. ensure continual risk monitoring by management. 4.6. ensure that management considers and implements appropriate risk responses. 4.7. determine the levels of risk tolerance and the board must set levels of risk tolerance once a year. 4.8. receive assurance regarding the effectiveness of the risk management process. 4.9. receive assurance regarding the effectiveness of the risk management process. 4.10. The risk committee or audit committee should assist the board in carrying out its risk responsibilities.
5. Governing stakeholder relationships	The board should: 5.1. appreciate that stakeholders' perceptions affect a company's reputation. 5.2. delegate to management to proactively deal with stakeholder relationships. 5.3. strive to achieve the appropriate balance between its various stakeholder groupings, in the best interest of a company. 5.4. ensure that disputes are resolved as effectively, efficiently and expeditiously as possible. 5.5. companies should ensure the equitable treatment of shareholders.
6. Internal audit	6.1. The board should ensure that there is an effective risk based internal audit.

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	6.2. Internal audit should follow a risk-based approach to its plan. 6.3. Internal audits should provide a written assessment of the effectiveness of the company's system of internal controls and risk management. 6.4. The audit committee should be responsible for overseeing internal audit. 6.5. Internal audit should be strategically positioned to achieve its objectives.
7. Compliance	7.1. The board should ensure that the company complies with applicable laws and considers adherence to non-binding rules, codes and standards. Obviously, companies must comply with all applicable laws. Even if it is not law, companies must consider adherence to non-binding rules, codes and standards. 7.2. Compliance with laws should not be a mindless compliance with rules, but should be considered as an expression of ethical rules and standards. 7.3. Compliance also entails benefiting from the rights afforded by the law. It also entails an understanding of the laws in a broader context, to achieve this the following principles are important. 7.4. The board and each individual director should have a working understanding of the effect of the applicable laws, rules, codes and standards on the company and its business. 7.5. Compliance risk should perform an integral part of the company's risk management process. 7.6. The board should delegate to management the implementation of an effective compliance framework and processes.
8. Governance of information technology	The board should: 8.1. responsible for Information Technology (IT) governance. 8.2. delegate to management the responsibility for the implementation of an IT governance framework. 8.3. monitor and evaluate significant IT investments and expenditure. 8.4. ensure that information assets are managed effectively. 8.5. make sure that IT forms an integral part of the company's risk management. 8.6. ensure that IT is aligned with the performance and sustainability objectives of the company. 8.7. see that a risk committee and audit committee assist the board in carrying out its IT responsibilities.

Source: *Conceptualised from King Report III (2009).*

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