CHAPTER THREE: AN OVERVIEW OF GOVERNANCE

3.1 Structure of chapter

As indicated in chapter one information is the livelihood of modern organisations.[1] Not only has the function, role and use of information within the business environment changed dramatically but the nature, volume and sensitivity of information used by organisations have expanded exponentially. Interconnectivity, the advent of the Internet and the borderless environment in which business is being conducted are just some of the drivers of these changes.[2] Inevitably new concerns for security are being raised. It follows therefor that great emphasis is being placed on information security, and that a new governance discipline namely, information security governance, is evolving. Before an investigation can be launched into what this discipline entails it is necessary to explore what the concept of governance itself encompass as well as how it was institutionalised in South African law.

The objective of this chapter is therefor to address three principal questions, namely:

(i) What is governance?

(ii) How was governance introduced into South African law? and

(iii) How can the board and top management extend the governance discipline to information security?

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[1] Organisations are expecting of their IT departments to provide them with information that will enable the organisation to take full advantage of its information so that it can maximise the benefits of this information, capatalise on opportunities and sustain competitive advantage.

[2] Conger, Lawler and Finegold *Corporate Boards* (2001) 140.

Outline of chapter:

Part 2: will define governance and briefly discuss its essential qualities;

Part 3: will identify corporate governance as the method by which governance was introduced into South African law and will provide the reader with a timeline that highlights the most important stages in the corporate governance evolution;

Part 4: provides the reader with an introduction to governance in the information age; and

Part 5: will examine the enforceability of governance.

It is concluded that the concept of governance is concerned with setting organisational strategy, managing risks, measuring performance and delivering value. Primary drivers of governance are the increased demand for transparency, accountability and responsibility, with the ultimate objective of an increase in shareholder value. The concept of governance was introduced into the South African law with the issuing of the King report on Corporate Governance in 1994. Since then the advent of the information age resulted in organisations being dependent on information technology for their success and growth. Interconnectivity, and more specifically the ease with which information may be accessed and transmitted, inevitably highlights the need for improved information security practices. The board and management will therefor have to make information security governance an integral part of their organisation

Throughout this dissertation it should be borne in mind that corporate governance, information technology governance and information security governance are all subdivisions of the overall governance concept.

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3.2. Governance

3.2.1 Introduction

Organisations focus their attention on the issue of governance whenever they have to make important decisions on issues pertaining to, for instance mergers[3], acquisitions, joint ventures[4] or outsourcing.[5] Through this process of due diligence organisations want to satisfy themselves about the nature, reputation and capabilities of the organisation they are about to do business with.[6] They want reassurance that the organisation will be able to deliver against present and future expectations.[7]

In the last decade the issue of governance has received renewed attention. The traditional perception of governance is being challenged by different interest groups, ranging from stakeholders, the community, to government.[8] Investors are becoming more active and the media have adopted the role of a watchdog.[9] This was as a direct result of the recently publicised corporate failures illustrating how managers and other top ranking officials can, with a certain degree of ease, allocate company resources for their own personal benefit.[10] Consequently, attempts have been made to hold top management and the board more accountable to the stakeholders of the organisation. The results of these efforts are evident in practice.[11]

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[3] For purposes of this research paper a merger (amalgamation) may be viewed as a transaction whereby the assets of two or more business concerns are placed into one.

[4] A joint venture may be defined as a partnership between two legal persons, for instance companies.

[5] IT Governance Institute "Board briefing on IT governance" (last visited 18 November 2002) http://itgovernance.org 6.

[6] ibid.

[7] ibid.

[8] Cannon *Corporate Responsibility* (1994) 131.

[9] (n 2) xiv.

[10] An excellent example of this would be the Enron scandal. For a comprehensive discussion on this scandal, consult Widen "Enron at the margin" (May 2003) *The Business Lawyer* 961.

[11] Some examples of these practices include:

(i) Formal assessment of top management by the board, as well as an independent assessment of the board itself;
(ii) Demand the involvement of outside directors;
(iii) When it comes to appointment of the board ensure representatively of the society in which the organisation functions;
(iv) Hold meetings with outside directors;
(v) Require of directors to own stock in the company; and
(vi) Require the board to have a charter which provides guidelines on how it is suppose to perform its functions Conger (n 2) xiv.

3.2.2 Defining governance

Several definitions of governance have been advanced.[12] The King II report views governance as being mainly concerned with two notions namely, performance and conformance.[13] The report argues that the challenge lies in finding an equilibrium between these two notions.[14] It is therefor expected of organisations to find a balance between shareholders expectations to generate the highest possible income, while simultaneously acting in a responsible manner when attempting to achieve this goal.[15] King II furthermore suggests that the governance in a society "reflects the value system of the society in which it operates."[16] How management wishes to govern their organisation will therefor not only depend on the society in which they operate, but also on the country in which they do business.[17]

The definition of governance as set forth by the Bank for International Settlements has been adopted for purposes of this dissertation. It defines governance arrangements as:

> "[E]ncompassing the set of relationships between the entity's management and its governing body, its owners and its stakeholders and providing the structure through which:
>
> (i) The entity's overall objectives are set;
>
> (ii) The method of obtaining those objectives are outlined; and

---

[12] Roulier "Governance issues and banking system soundness" in Enoch and Green *Banking Soundness and Monetary Policy* (1997) 450 views governance as a system that "…defines the relationship of the owners to their firm and the mechanism through which the owners affect the institution's behaviour…". Cannon (n 8) 135 is of the opinion that the concept of governance entails "…the sum of those activities which make up the internal regulation of the business in compliance with the obligations placed on the firm by legislation, ownership and control. It incorporates the trusteeship of assets, their management and their deployment." Governance should however not be confused with management. The inherent difference between governance and management may be described as follows: "(e)veryone plays a role in governance, because governance is aimed at reaching the organisation's goals. Governance equals 'direct' and 'control' while management equals 'plan,' 'organize,' 'direct' and 'control.' Governance is responsible for making sure the management framework is in place…not for executing it." Unknown "IT governance round table" (last visited 8 July 2002) http://www.itgovernance.org/itgovround3.htm 1-2.

[13] King Committee *King II Report on Corporate Governance 2002* (2002) 8.

[14] ibid.

[15] ibid.

[16] (n 13) 18.

[17] Cohen and Boyd *Corporate Governance and Globalization* (2000) 1.

(iii) The manner in which performance will be monitored is described."[18]

Governance may therefor be seen as the positioning of checks and balances on the stewardship of the organisation.[19]

3.2.3 Relationship between stewardship and governance

Generally the duty of proper stewardship is placed in the hands of those responsible for the goods and funds of stakeholders.[20] Therefor the ultimate responsibility for stewardship of the organisation will reside in the board of directors, as they are seen as the "guardians of assets".[21]

It is contended by Cannon[22] that effective stewardship represents a two-way street of trust and confidence. Investors need to trust management otherwise they will stop investing

18 (n 5) 9-10.

19 Dott "Living in glass houses: good governance and how to achieve it" (last visited 20 September 2002) http://www.itweb.co.za 1.

20 The first King report defined stakeholders as: "…any person, entity or interest group that has some association with the company." There are three classes of stakeholders: shareholders, parties who contract with the company and parties who have a non-contractual nexus with the company. An example of a contracting party is the employee and a non-contracting party is the State. King II defines stakeholders as: "…the community in which the company operates, its customers, its employees and its suppliers. The relationship between a company and these stakeholders is either contractual or non-contractual…" Cannon (n 8) compiled a comprehensive list of people who he identified as being stakeholders. He furthermore categorised these stakeholders into a primary and secondary group. The primary group would include shareholders, employees, customers, suppliers, collaborators, government and extra government bodies. The secondary group would include groups and agencies concerned with the environment, media, law, ethics and standards, communities and academics. Different stakeholders will expect different things from the company. Cannon distinguishes between the following stakeholders, and prioritise their expectations as primary and secondary:

Stakeholder	**Expectations**	**Expectations**
	Primary	**Secondary**
Owners	Financial returns	Added value
Employees	Pay	Work satisfaction and training
Customers	Supply of goods and services	Quality
Creditors	Credit worthiness	Security
Suppliers	Payment	Long-term relationships
Community	Safety and security	Contribution to community
Government	Compliance	Improved competitiveness

21 (n 8) 79.

22 (n 8) 139.

money in the company, but in order to attain the trust of the investors a need for greater disclosure, transparency and accountability from top management exist.[23] On the other hand management needs to be reassured that investors are confident of their competence to manage the affairs of the organisation, if not management will loose faith in itself.[24] Cannon[25] is of the opinion that internal systems and voluntary codes should be seen as the key to sound stewardship. It will act as a monitoring system to ensure that directors properly exercise their duties, and do not exceed their authority.[26]

3.2.4 Nature of governance

Governance may be summarised as being concerned with the following functions:[27]

(i) Setting strategy;[28]

(ii) Managing risks;[29]

(iii) Measuring performance;[30] and

(iv) Delivering value.[31]

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Ultimately governance is concerned with ensuring that those people entrusted with the investments and funds of others act in a responsible manner in order to safeguard stakeholders and shareholders interest, and ensure that shareholders receive the greatest

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23 ibid.
24 ibid.
25 ibid.
26 ibid.
27 An effectively implemented information security governance discipline will deliver these four outcomes. Keep in mind that performance measurement and strategic alignment have a dual function. Not only do they represent the outcomes delivered by information security governance, they are also drivers of the other two outcomes risk management and value delivery.
28 (n 5) 10.
29 ibid.
30 ibid.
31 ibid.

return on investment (ROI).[32] The ultimate responsibility for good governance of an organisation lies in the hand of the board of directors.[33]

3.3 Corporate Governance: the catalyst of change

The concept of governance was introduced into South African law through corporate governance, as embodied in the King report on Corporate Governance.[34]

3.3.1 Defining corporate governance [35]

Literature on corporate governance are contaminated with inadequate definitions of corporate governance. Corporate governance is defined by the Cadbury Report on Financial Aspects of Corporate Governance as "the system by which companies are directed and controlled."[36] The report goes on to state that "corporate governance is concerned with holding a balance between economic and social goals and between individual and communal goals… the aim is to align as nearly as possible the interest of

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[32] (n 17) 4.
[33] (n 8) 140.
[34] (n 13) 1.
[35] Some of the more acceptable definitions are advanced by Deakin and Hughes "Comparative corporate governance: an interdisciplinary agenda" 24 (1997) *Journal of Law and Society* 2 "(c)orporate governance is concerned with the relationship between internal governance mechanisms of corporations and society's conception of the scope of corporate accountability." Davids and Daniels "US corporations in globalization" (n 139) 190 view corporate governance as: "…consisting of an interrelated set of mechanisms relating to board of directors, ownership structures, institutional and relational investors, and government and other stakeholder groups that influence firm-level decisions over resource allocation aimed at maximising shareholders' return." Dott (n 19) 1 views corporate governance as: "…a framework for the management and accountability of key decision-making bodies…". Steyn "Corporate governance" (last visited 18 November 2002) http://www.mbendi.co.za/werksmns/wkcrp02.htm 1 describes corporate governance as: "…a system by which companies are directed and controlled and is relevant where there is a division between the ownership of the equity and the directors of the company." It is contended by Steyn that the main culprit responsible for the numerous corporate failures experienced recently is the separation between ownership and management, and the lack of control shareowners exercise over the company.
[36] Smerdon *A Practical Guide to Corporate Governance* (1998) 1.

individuals, corporations and society."[37] This definition advanced by the Cadbury report was also adopted by the first and second King report on Corporate Governance.[38]

A broader definition of corporate governance is advanced by the Organisation for Economic Co-operation and Development (henceforth OECD). This definition has been adopted by the researcher for purposes of this dissertation.[39] The OECD defines corporate governance as "a set of relationships between a company's management, its board, its shareholders and other stakeholders, providing a structure through which the objectives of the company are determined and performance is monitored."[40]

The OECD goes further to state that the corporate governance concept has two facets to it, namely (i) a behavioural side, and (ii) a normative side.

(i) "Corporate governance encompasses the relationships and ensuing patterns of behaviour between different agents in a limited liability corporation, the way managers and shareholders but also employees, creditors, key customers and communities interact with each other and give shape to a company's strategy and identity in the capital, goods and labour market."[41]

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(ii) "…corporate governance also refers to a set of rules that frame private behaviour. These include company law, securities regulations and listing requirements. But they may also be private norms, such as self-regulation in the form of codes. These are soft rules that rely on reputational mechanisms for their implementation."[42]

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[37] Cadbury "Corporate Governance Overview" (1999) *World Bank Report* 35.
[38] King Committee on Corporate Governance *The King Report on Corporate Governance South Africa: The Institute of Directors in Southern Africa* (1994) 1.
[39] The researcher favours this broad definition as it addresses both the behavioural and normative side of corporate governance.
[40] Organisation for Economic and Co-operation and Development "OECD principles of corporate governance" (last visited 24 July 2002) http://oecd.org 11.
[41] ibid.
[42] ibid.

3.3.2 Nature of corporate governance

Good corporate governance is identified by the following characteristics:

(i) **Discipline:** This characteristic entails top management being committed to and accepting responsibility for good corporate governance and behaving like a respectable corporate citizen.[43]

(ii) **Transparency**: It is expected of management to give investors a clear, accurate and up-to-date representation of current state of affairs of the company.[44] As stated by Cannon[45] "secrecy breeds suspicion while openness is the most public symbol of a clear conscience." The test of transparency lies in the answer to the question: how easy is it for an outsider to gain insight into the workings of the organisation?[46]

(iii) **Independence**: This characteristic deals with safeguards that must be implemented to limit, reduce and where possible exclude the possibility of a conflict of interest materialising.[47]

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(iv) **Accountability**: All employees of the company are answerable to investors for activities performed, and decisions made within the scope of their employment, regardless of the position held by them in the company.[48]

(v) **Responsibility**: Management must be held accountable for any actions or decisions that may have a detrimental effect on the company.[49] The

43 (n 13) 11.
44 (n 13) 12.
45 (n 8) 320.
46 Kemp "King II in a nutshell." (last visited 2 August 2002) http://m1.mny.co.za/cfcgvn.nsf…/ 3.
47 (n 13) 12.
48 ibid.
49 ibid.

concept of responsibility also embodies corrective action that will have to be taken.[50]

(vi) **Fairness**: It is the responsibility of the company to act in a fair and reasonable manner towards all parties who have an interest in the company, regardless of the individual or group's attributes.[51]

(vii) **Social responsibility**: The industrial revolution placed the focus on corporate responsibility.[52] Because of the world-wide realisation that corporate activities and decisions impact upon and influence the community as a whole, organisations and society are beginning to analyse and evaluate current practices and standards of organisations.[53] In the past emphasis was placed on creating shareholder value. There is however an emerging trend amongst companies to acknowledge that they also have a social responsibility.[54]

A good corporate governance practice will furthermore possess over the following attributes:

(i) **Direction**: An effective corporate governance system will enable the organisation to set objectives and targets.[55] The formulation, development, implementation and monitoring of the strategic direction of the company is one of the four main activities to be performed in corporate governance. This would involve revisiting and re-evaluating the strategy of the company on a continuous basis in order to ensure it

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50 (n 46) 3.
51 (n 13) 12.
52 (n 8) 2.
53 (n 8) 50.
54 Martin "The virtue matrix: calculating the return on corporate responsibility" (March 2002) *Harvard Business Review* 70.
55 (n 40) 11.

does not become outdated or restrictive on the company's evolution and growth.[56]

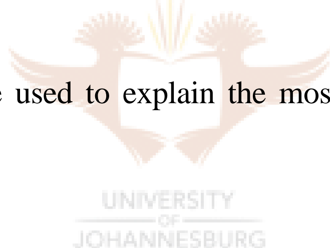
(ii) **Executive action**: Executives need to be able to make informed decisions, based on timely, accurate and reliable data.[57]

(iii) **Supervision**: The performance measurement of managerial activities and decisions must take place on a regular basis, and the findings of such a process must be reviewed and reported on.[58]

(iv) A trustworthy, honest **relationship** between the management, board, its shareholders and stakeholders must exist.[59]

(v) Managers and directors must be **motivated** by incentives to reach identified goals and targets.[60]

3.3.3 Evolution of corporate governance[61]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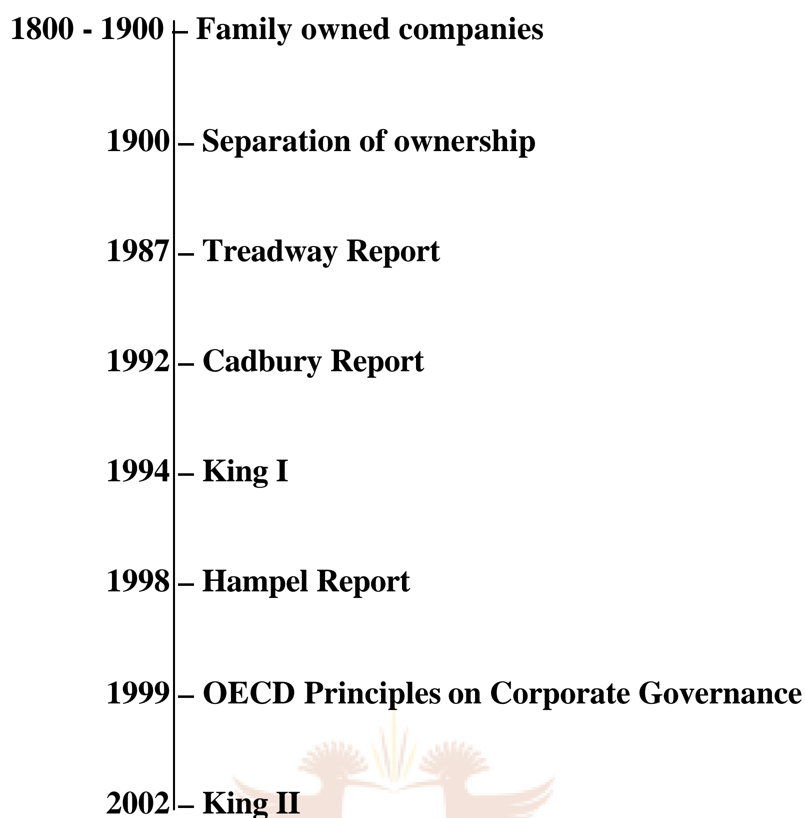
The following timeline may be used to explain the most significant development in the field of corporate governance:

[56] Tricker *Corporate Governance* (1984) 7.
[57] ibid.
[58] ibid.
[59] (n 40) 11.
[60] ibid.
[61] Consult Annexure A for regulatory reports and emerging standards on governance.



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1800 - 1900

Up until the nineteenth century companies were mostly owned by families.[62] As a result of this the roles of ownership and management in these companies were seldom separated. Positions were filled based on family-ties and relationships.[63] Qualifications and skills were seen as being of secondary importance compared to family loyalties.[64] One of the most significant corporate governance problems facing these companies were that there was "no outside interest in the firm."[65] Owners/managers were very subjective, closed and uncompliant to any new business opportunities and/or changes in the business environment which inevitably necessitated changes in the organisation itself.[66]

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62 Reinecke *Effective Corporate Governance – A South African Perspective* (1996 thesis RAU) 2.
63 (n 8) 2.
64 ibid.
65 Berglöf and Von Thadden "The changing corporate governance paradigm: implications for developing and transition economics" in Cohen and Boyd (n 17) 286.
66 Some examples of family-based firms that suffered from this corporate governance problem were Wang in the United States of America and Grundig in Germany.

1900

The nineteenth century found a break in this pattern when companies started to make use of professional managers for the day-to-day running of the company, effectively allowing "outsiders" into the company and focussing their attention on the qualifications and expertise of these managers.[67] These professional managers (directors) had full managerial authority and acted as agents of the company.[68] Owners of the company did however become uneasy with the considerable amount of power vested in these "outsiders," and wanted a way in which to protect their investments against fraudulent directors.[69]

The separation of ownership therefor represents a two-edge sword. On the one side, as a result of the separation of ownership the "agency problem" was created,[70] and on the other side that separation of ownership, and ultimately the "agency problem" resulted in the genesis of corporate governance.[71] Therefor corporate governance principles emerged as a direct result of shareholders becoming uneasy with the magnitude of power in the hands of management. Corporate governance offered a safety mechanism for shareholders and stakeholders alike.[72]

1987 - Treadway Report

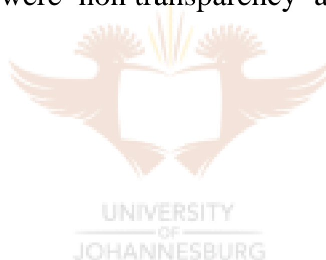
The phrase "corporate governance" originated in America.[73] This term was used in American law journals quit frequently in the 1970, and the United Kingdom proceeded to import it.[74] Various investigations have since been launched into the nature of corporate

67 (n 62) 3.
68 ibid.
69 ibid.
70 ibid.
71 ibid.
72 (n 13) 9.
73 (n 36) 1.
74 ibid.

governance, each investigation resulting in its own report.[75] The first noteworthy development in corporate governance occurred in 1987 when the National Commission on Fraudulent Reporting issued the "Treadway Report" in the United States.[76] Shortly thereafter, in 1991 one of the most important developments in the field of corporate governance occurred with the issuing of the Cadbury report.[77]

1992 - Cadbury Report

In May 1991 Sir Adrian Cadbury was asked to chair a Committee on the Financial Aspects of Corporate Governance.[78] The formation of the committee was as a result of various scandals[79] that took place in the late 1980's,[80] coupled with the demand for greater accountability by stakeholders and shareholders.[81] Two of the biggest problems experienced during this time were non-transparency and the uncertainty surrounding remuneration of executives.[82]



75 (n 62) 2.
76 (n 62) 1.
77 (n 62) 2.
78 Sir Cadbury was designated for this specific task by the Financial Reporting Council, the London Stock Exchange and the accountancy profession.
79 An example of such a scandal include the disintegration of the Maxwell Group as a result of the founder of the Group, Robert Maxwell disappearing. Thousand of pensioners were left without pension.
80 Keasy and Write *Corporate Governance: Responsibilities, Risk and Remuneration* (2001) 1-2 suggest that the following reasons may be advanced for the problems experienced during the 1980's:

(i) "Creative accounting;
(ii) Spectacular business failures;
(iii) The apparent ease of unscrupulous directors in expropriating other stakeholder's funds;
(iv) Limited role of auditors; and
(v) The claimed weak link between executives compensation and company performance."

81 (n 36) 1.
82 (n 36) 2.

The final Cadbury Report on Financial Aspects of Corporate Governance was issued on December 1, 1992. [83]

The Cadbury Report centers around financial aspects of corporate governance.[84] One point of criticism launched against this report is the fact that its pertinence is limited to questions pertaining to accounting aspects of corporate governance.[85]

The Cadbury Report made recommendations on how the classical UK model should be modified, adapted and amended. The aim of these changes would be to ensure that executives and managers are answerable to shareholders and stakeholders. [86] The relevance of this within the South African context is that the South African Companies Act 61 of 1973 is to a great extent based on the United Kingdom Companies Act. [87]

Principal recommendations made by the committee included the following:

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[83] It appears as if the Cadbury Report strives to find a balance between the stakeholder and shareholder value theory.
The following characteristics of the classical United Kingdom model may be identified:
(i) The company is seen as a separate legal entity;
(ii) The power to govern the company is vested in the owners of that company;
(iii) The board of directors are answerable to the owners regarding their activities and decisions. They are also responsible for the day-to-day running of the company;
(iv) It is within the scope of the owners' authority to appoint independent auditors to investigate the accuracy and reliability of the financial statements of the company; and
(v) Because of the fact that shares may be transferred the company can exist indefinitely.
The classical UK model and the Cadbury framework differ in the following ways:
(i) It is required of directors to disclose in their annual reports the effectiveness and efficiency of internal controls. The annual report must also contain a statement stating that the company is a going concern. Auditors must endorse both these statements;
(ii) An audit committee compris ing of mostly non-executive directors must be brought into existence. The committee will be responsible for the review, assessment, monitoring and reporting on all reports, statements and documents pertaining to the subject matter of accounting. The chairman of this committee must be a non-executive director; and
(iii) The chairman of the board of directors must be a non-executive.
Macdonald and Beattie "The corporate jigsaw" *Accounting and Business Research, Corporate Governance Special Issue* 23 (1993) 305.

[84] Keasy and Write *Corporate Governance: Responsibilities, Risk and Remuneration* (2001) 1.

[85] (n 84) 2.

[86] The Cadbury Committee *The Financial Aspects of Corporate Governance* (1992) 54-60.

[87] (n 62) 14.

(i) It is required of this committee to meet with external auditors at least once a year, without the executive directors being present.[88]

(ii) It is furthermore required of organisations to appoint a remuneration committee that will have to decide on executive remuneration. It is suggested that this committee comprise mostly, and if at all possible, solely of, non-executive directors.[89]

(iii) In order for a director to be appointed for a time-period longer than three years the consent of shareholders must first be obtained.[90]

(iv) The chairman and chief executive officer must have two independent functions and responsibilities.[91] An unequivocal separation of the two roles are required.

(v) It is required that the remuneration of the chairman, as well as that of directors must be disclosed.[92]

(vi) Documentation must be drafted that draws a clear distinction between salary and performance-related pay. The latter must furthermore be explained in detail in this document.[93] Internal financial controls and going concern should receive attention, specifically in the area of assessment of efficiency and effectiveness.[94]

(vii) Great emphasis is placed on the role of independent directors pertaining to their appointment, independence and fees.[95]

1994 - King I

Corporate governance was institutionalised in South Africa in the form of the King Report on Corporate Governance in November 1994. The King Committee on corporate

88 (n 8) 320.
89 (n 84) 4.
90 ibid.
91 ibid.
92 ibid.
93 ibid.
94 ibid.
95 (n 8) 320.

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governance was founded in 1992, and chaired by Mervyn King.[96] The committee's main objective was to investigate the findings of the Cadbury report and determine how these findings could effectively be implemented in South Africa, having specific regard to the unique circumstances prevailing in South Africa, and taking into account concerns over recent corporate failures experienced worldwide.[97]

The final King I Report was issued on 29 November 1994. The first King report subscribed to most of the Cadbury findings, but did not limit itself to financial aspects of corporate governance.[98] The report contained amongst other things:

(i) Recommendations on corporate governance principles;

(ii) A "Code of ethics for enterprises and all who deal with enterprises"; and

(iii) "Affirmative action guidelines" aimed at uplifting members of the community that were previously disadvantaged as a result of the Apartheid era.[99]

The report furthermore acknowledged that companies have a financial, social, ethical and environmental responsibility.[100] It required of companies to become good, responsible corporate citizens.[101]

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1998 - The Hampel Report

The Hampel Report was drafted by the Hampel Committee on Corporate Governance and published in January 1998.[102] In the introduction to this report the following statement is made: "the importance of corporate governance lies in its contribution both to business

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96 (n 62) 2.

97 In South Africa the Masterbond failure in 1991 confirmed the fact that South Africa was not immune to problems pertaining to corporate governance. As a result of Masterbond numerous public investors lost money. The investors claimed that they had suffered a loss due to the fraudulent actions of the company's directors and demanded retribution. The law did however not agree and afforded them very little to no protection.

98 (n 62) 3.

99 (n 62) 2.

100 (n 13) 7.

101 For criticism launched against this report, consult Wixley and Everingham *Corporate Governance* (2003) 68-69.

102 (n 36) 1.

prosperity and to accountability."[103] It is contended by this report that the first responsibility of the board should be to "enhance the prosperity of the business over time."[104]

1999 - The Organisation for Economic Co-operation and Development

The Organisation for Economic Co-operation and Development issued a set of corporate governance standards and guidelines.[105] These principles were adopted by OECD ministers in May 1999. The ultimate goal of the OECD principles on corporate governance is to improve transparency, integrity and the rule of law.[106] The purpose of these guidelines were to provide countries with an acceptable international standard against which they could benchmark themselves.[107]

OECD principles of corporate governance may be summarised as follow:[108]

Topic/Principal area	Principle	Critical assessment
1. The rights of shareholders	The corporate governance framework of a country should protect shareholders.[109] **Supporting recommendation:** 1. Shareholders possess over the following basic rights, the right to: • Secure method of ownership registration;[110] • Convey or transfer of shares;[111]	Emmons and Schmid[120] are of the opinion that although the report recognises the agency problem, it does not propose any solutions to this problem. It is furthermore felt that the "one-share-one-vote" rule is not advanced as a possible solution.

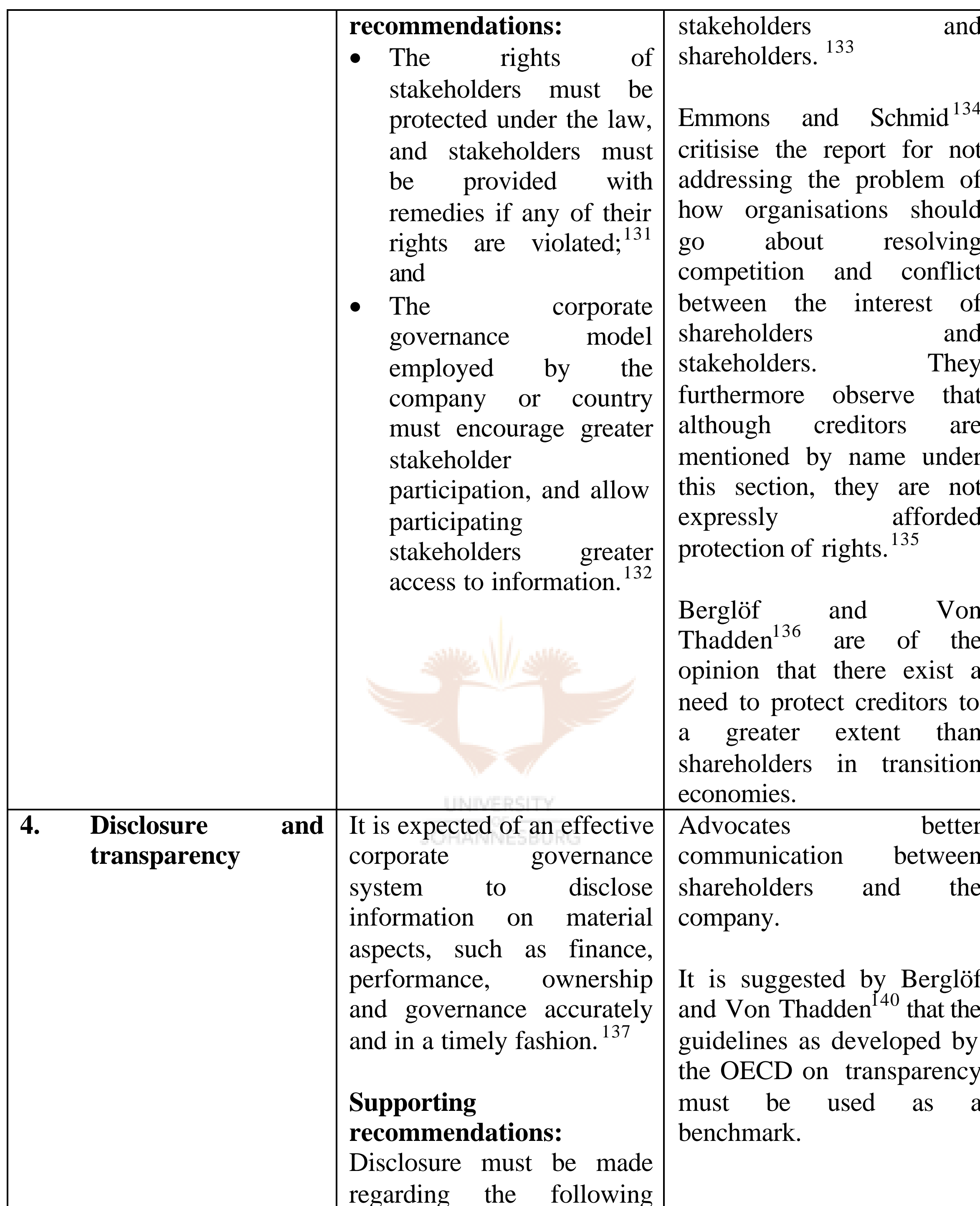
[103] Hampel Committee *Committee on Corporate Governance – Final Report* (1998) 212.
[104] (n 103) 214.
[105] Emmons and Schmid "Corporate governance and corporate performance" in Cohen and Boyd (n 17) 60.
[106] (n 40) 8.
[107] ibid.
[108] (n 105) 63-64.
[109] (n 40) 17.
[110] ibid.
[111] ibid.

	• Be provided with accurate, current information on a regular basis;[112] • Participate and vote in general meetings;[113] • Elect members of the board;[114] and • Share in the profit of the organisation.[115] 2. Shareholders should be involved in decisions pertaining to: • Amendment of statute, articles of association or any relevant company document;[116] • Must authorise additional shares;[117] and • Extraordinary transactions that results in the sale of the company.[118] 3. Shareholder must be given due notice of general meetings and must furthermore be allowed to participate and vote in these meetings in person or in absentia.[119]	
2. The equitable treatment of shareholders	The corporate governance structure of a country must protect all shareholders and	Under this section emphasis is placed on increased disclosure of information to

[112] ibid.
[113] ibid.
[114] ibid.
[115] ibid.
[116] ibid.
[117] ibid.
[118] ibid.
[119] ibid.
[120] (n 105) 63-64.

	afford them equal treatment.[121] This principle was introduced having specific regard to the rights of minority and foreign shareholders.[122] **Supporting recommendation:** All shareholders of the same class must be treated equally.[123] • The grievances of a minority shareholder must receive the same attention and degree of urgency as that of a majority shareholder;[124] • Insider trading and abusive self-dealing is prohibited;[125] and • All material matters of the company must be disclosed by the board to shareholders.[126]	shareholders.[127] The rights of shareholders, especially minority and foreign shareholders are afforded protection but yet again the "one share one vote" rule is neglected.[128] Although the report identifies shortcomings in the corporate governance systems applied by countries it does not endeavor to prescribe drastic reform measures. Emmons and Schmid[129] observe that the report only makes suggestions regarding disclosure of principles or practices that may be detrimental to this specific type of shareholder.
3. The role of stakeholders	The corporate governance framework employed by the country must acknowledge the important role stakeholders play within the organisation, and attempt to involve them wherever possible.[130] **Supporting**	Stakeholders are defined in broad terms and include, but are not limited to employees, suppliers, creditors and non-shareholders who have an interest in the company. The report does not foresee any potential problems that may arise between

121 ibid.
122 (n 40) 19.
123 bid.
124 ibid.
125 ibid.
126 ibid.
127 (n 105) 63.
128 ibid.
129 ibid.
130 (n 40) 20.
131 ibid.
132 ibid.



	recommendations: • The rights of stakeholders must be protected under the law, and stakeholders must be provided with remedies if any of their rights are violated;[131] and • The corporate governance model employed by the company or country must encourage greater stakeholder participation, and allow participating stakeholders greater access to information.[132]	stakeholders and shareholders.[133] Emmons and Schmid[134] critisise the report for not addressing the problem of how organisations should go about resolving competition and conflict between the interest of shareholders and stakeholders. They furthermore observe that although creditors are mentioned by name under this section, they are not expressly afforded protection of rights.[135] Berglöf and Von Thadden[136] are of the opinion that there exist a need to protect creditors to a greater extent than shareholders in transition economies.
4. Disclosure and transparency	It is expected of an effective corporate governance system to disclose information on material aspects, such as finance, performance, ownership and governance accurately and in a timely fashion.[137] **Supporting recommendations:** Disclosure must be made regarding the following	Advocates better communication between shareholders and the company. It is suggested by Berglöf and Von Thadden[140] that the guidelines as developed by the OECD on transparency must be used as a benchmark.

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133 (n 105) 63.
134 ibid.
135 ibid.
136 (n 65) 301.
137 (n 40) 21.
138 ibid.
139 ibid.
140 (n 65) 300.

	issues: • Company objectives; • Governance structure and policies; • Material foreseeable risk factors; • Material issues affecting employees and stakeholders; • Members of the board, key executives and their remuneration; • Major share ownership of company and voting rights; and • Financial and operational performance of the organisation.[138] Financial statements must be verified by an independent auditor.[139]	
5. The responsibilities of the board	The corporate governance system must ensure and assess the monitoring and accountability of the board, and determine, support and enable the strategic direction of the company.[141] The board is answerable to the shareholders, and the board in turn is responsible for the monitoring of management.[142] **Supporting recommendations:** The board is placed under a multitude of onerous responsibilities, including, but not limited to: • Ensuring that all shareholders are treated	Recognises that in order for the board to fulfill its functions to the best of its ability the board must stand independent from management. It is furthermore suggested that the board's principal objective is to act in the best interest of shareholders, stakeholders and the general society.

[141] (n 40) 22.
[142] ibid.

	in a fair and just manner;[143] • Ensure that applicable laws, regulations and standards are complied with;[144] • At all relevant times act in the best interest of the stakeholders;[145] and • Act bona fide, in the best interest of the company and with due diligence.[146] The key functions the board is expected to perform is also given attention.[147] It is acknowledged that the board will only be able to discharge its responsibilities if it has access to timely, accurate and relevant information.[148]	

The principles of corporate governance as identified by the OECD are just one of twelve principles of financial stability participating countries are expected to adhere to. It is contended by Nestor[149] that these principles have gained widespread international acceptance. It is however important to bear in mind that these principles are non-binding, but may be seen as a reference point that can aid organisations and countries to evaluate and develop an effective corporate governance system.[150]

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143 ibid.
144 ibid.
145 ibid.
146 ibid.
147 ibid.
148 (n 40) 23.
149 Organisation for Economic Co-operation and Development *The IFLR Guide to Corporate Governance* (2001) 18. It is interesting to observe that the new listing requirements of the Johannesburg Stock Exchange (JSE) subscribe to most of these recommendations.
150 (n 40) 8.

2002 - King II

The aim of King II is "to bring corporate governance in line with best international practices."[151] The report's was released on 26 March 2002. It reviewed the corporate governance standards applicable in South Africa, taking into account changes and developments that have occurred since the issuing of the first King report.[152] The report augments on the first King report by:

(i) Re-assess the appropriateness and applicability of the recommendations made in the first King report, in the light of the present economical, political and social climate;[153]

(ii) King II focuses attention on the activities of non-executive directors, a role-player whose activities and responsibilities have been largely ignored in the past;[154]

(iii) Acknowledge the importance of non-financial measures and incorporate these measures into a monitoring and reporting mechanism; [155] and

(iv) Recommends measuring and reporting on compliance with the new Code of Corporate Governance, and that organisations should make use of the balanced scorecard approach[156] to monitor, measure and report on performance.[157]

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[151] Van Zyl "King II puts pressure on all" (last visited 22 August 2002) http://wwww.news24.com 1.
[152] (n 13) 16.
[153] ibid.
[154] (n 2) 1.
[155] (n 13)16.
[156] The balanced scorecard is a management concept that comprises of trends, targets and benchmarks. It may be seen as a set of measures used on a regular basis to manage and evaluate your organisation's department's, and unit's performance, giving you a balanced, up-to-date and accurate view of the performance of the area that falls within your field of expertise and responsibility. For a more comprehensive discussion on the balanced scorecard see chapter five hereafter.
[157] (n 13) 16.

3.3.4 Corporate governance models – a comparative analysis

As a result of the coming of age of corporate governance certain models have crystalised. The culture, religion and history of a country will inevitably influence the corporate governance model/structure found in that country. It is therefor not surprising that no "single generally applicable corporate governance model exists."[158] There does however exist international guidelines on corporate governance which countries are expected to adhere to.[159]

Two predominant corporate governance traditions may be identified, namely civil law and common law.[160]

The following diagram will illustrate the segmentation that have occurred, and will indicate which country follows which tradition:[161]

158 (n 13) 15.

159 These guidelines have been developed by the Commonwealth Association for Corporate Governance, the International Corporate Governance Network, and the organisation for Economic Co-operation and Development (OECD). They have in common four characteristics: fairness, accountability, responsibility and transparency. Research done by La Porta, Rafael, Lopez-de-Silanes, Shleifer and Vishny suggest that one of the most important factors contributing to the fact that different countries have different corporate governance systems are the various legal traditions that exist amongst these countries. La Porta, Rafael, Lopez-de-Silanes, Shleifer and Vishny "Law and finance" (1998) 106 *Journal of Political Economy* 471-517.

160 (n 105) 66.

161 La Porta, Rafael, Lopez-de-Silanes, Shleifer and Vishny "Law and finance" (1998) 106 *Journal of Political Economy* Table 2.

Common law tradition (English origin) Originated from the English system. Characteristic of this system is that judges must resolve a particular case.[162]		**Civil Law Tradition** Originated from Roman law. Much older than its counterpart. Centers around statutes, regulations and codes. It is left up to legal scholars to interpret and mold the civil law.		
Legal Families		**Scandinavian origin**[163]	**German origin**[164]	**French origin**
OECD member countries[165]	Australia **Canada** Ireland New Zealand **United Kingdom** [166] **United States**[167]	Denmark Finland Norway Sweden	Australia **Germany**[168] **Japan**[169] South Korea Switzerland Netherlands	Belgium **France** Greece **Italy** Mexico Portugal Spain Turkey
Other	Hong Kong India Israel Kenya Malaysia Nigeria Pakistan Singapore **South Africa** Sri Lanka Thailand Zimbabwe		Taiwan	Argentina Brazil Chile Colombia Ecuador Egypt Indonesia Jordan Peru Philippines Uruguay Venezuela

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[162] It is suggested by Berglöf and Von Thadden (n 65) 300 that Anglo-Saxon common law systems are company based.

[163] French and Scandinavian countries were traditionally enterprised-based, but they are currently undergoing a transformation.

[164] Organisations with German roots are normally enterprised based.

[165] The countries in bold make up the G7 members.

[166] The UK corporate model is company-based. The emphasis is placed on the relationship between the organisation and its investors. The organisation is typically seen as an independent entity. Security markets are seen as being of critical importance. Specific provision is made for the protection not only of shareholders against abuse, but also for the protection of minority shareholders. The board plays a pivotal role in this system and the board usually comprises of more non-executive directors than executive directors.

[167] In the US and UK the corporate governance system is market-based. Banks play a subordinate role in these systems.

[168] The German corporate governance model uses as its point of departure the so-called "two-tiered board of directors." This model entails that the board is divided into two separate entities, namely the supervisory board (Aufsichts rat), and the management board (Vorstand). The supervisory board monitors and oversee the activities performed by the management board. Members of this board are appointed by shareholders and employees. This board has the authority to appoint or remove a member of the management board. The management board is therefor answerable to the supervisory board. The management board is responsible for the day-to-day running of the company, including the performance of all management functions and activities. Germany makes use of a so-called enterprise based corporate system where great emphasis is placed on the physical entity (eg. the building, workers ect) and less emphasis is placed on the role of the market. Very few companies are listed, supervision and enforcement is a rare commodity. In Germany we find concentrated ownership, a general lack of take-over as well as securities market regulations. Other countries that are enterprise based include the Netherlands, Switzerland and Austria.

[169] The Japanese corporate governance model functions with a single tier board. In the board and executive committee a vast amount of power and authority is vested, and shareholder participation is limited as much as possible. In both the German and Japanese models banks play a pivotal role. However, the difference between these two models lie in the nature of the role that banks play. In Germany banks will directly influence corporate governance because it is one of the major shareholders, in contrast to Japan where banks adopt the role of financier.

From research done by La Porta et al[170] it is evident that countries in the common-law tradition have a better corporate governance practice than countries in civil law tradition.

3.3.5 Enforcement of corporate governance

The King II report will apply to "affected companies" whose financial year commences on or after 1 March 2002.[171] The newly enacted Johannesburg Stock Exchange (henceforth JSE) listing requirements place a legal obligation on companies listed on the JSE to follow the recommendations made by King II.[172] For unlisted companies it is seen as a "code of conduct" which may result in legal consequences for non-compliance. [173]

The following motivational "tools" may "move" the organisation to comply with the King II:

(i) The principles of good corporate governance are usually contained in existing legal rules and statutes. For instance the Companies Act[174] deals comprehensively with the role of a director in the company;[175]

(ii) Peer pressure;[176]

(iii) Shareowner activism; [177] and

(iv) The role of the media as a "watchdog."

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170 (n 161) 106.

171 The term "affected companies" refers to (i) companies listed on the JSE Securities Exchange South Africa; (ii) banks, financial and insurance entities; and (iii) public sector enterprises that falls under the Public Finance Management Act and Local Government: Municipal Finance Management Bill, including state departments.

172 The new JSE Listing Requirements came into effect on 1 September 2003, with some transitional arrangements. It sets forth certain mandatory aspects of corporate governance, requiring of listed companies to disclose the extend to which they comply with King II. The importance of corporate governance is reiterated by the fact that directors may be held liable, jointly or separately for transgressions of the Listing Requirements. Deloitte and Touche "Guide to JSE listing requirements" (last visited 18 November 2002) http://www.deloitte&touche.com 5-12.

173 Steyn "Corporate governance" (last visited 18 November 2002) http://www.mbendi.co.za/werksmns/wkcrp02.htm 1.

174 Act 61 of 1973.

175 (n 13) 143-144.

176 (n 13) 152.

177 (n 13) 150.

It is suggested by Lawler[178] that the continuous process of scrutiny, evaluation, re-evaluation and investigation into the actions of companies and specifically the board of directors embodies the "growing up" of South African corporate governance. He argues that this will result in better organisational performance and ultimately increase in shareholder value.[179] The reason why governance is of such great importance is because shareholders "believe in governance." Good governance fosters loyalty with them resulting in shareholders being more patient with the board and management in arduous times.[180]

The danger does however exist that corporate governance will become just another "buzz word," a catchphrase to be used whenever individuals or groups are dissatisfied with the way in which a company is performing its activities or management is discharging its responsibilities.[181] It should furthermore be guarded against seeing corporate governance as a "box-ticking" exercise or compliance strategy.[182] Consequently keep in mind that:

> "…the substance of good corporate governance is more important than its form; adoption of a set of rules or principles or of any particular practices or policy is not a substitute for, and does not itself assure good corporate governance."[183]

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3.4 Governance in the information age

"If there is a lack of good corporate governance in a market, capital will leave that market with the click of a mouse."[184]

[178] (n 2) 1.
[179] ibid.
[180] ibid.
[181] ibid.
[182] (n 19) 1.
[183] ibid.
[184] (n 13) 10.

The concept of information technology was introduced into South African law by King II. King I abstained from addressing the issue of information technology governance.[185] Not only does King II acknowledge that most companies are engaging in e-commerce, it also recognises that companies are at present very dependant on their information technology systems,[186] and that information technology forms an integral part of every business.[187] Information technology has emerged as a supporter and enabler of the business strategy, decisions and performance of the organisation.[188]

The digital revolution necessarily brings with it a multitude of new and onerous responsibilities, including, but not limited to issues pertaining to internal controls, reporting mechanisms, and fiduciary implications.[189]

Directors will have to educate themselves on information technology–related issues, having specific regard to the consequences and responsibilities associated with e-commerce and e-business.[190]

King[191] is of the opinion that a twenty-first century company will have to possess the following attributes in order to survive in the information age:

185 Körner "A route to IT governance: finding ROI in the IT haystack" (last visited 18 April 2002) http://www.itweb.co.za 1.

186 Kausch "King II report delivers good, bad news for IT" (last visited 20 August 2002) http://www.itweb.co.za 1.

187 Info Sec Africa press release "IT has significant impact on corporate governance" (last visited 20 August 2002) http://www.itweb.co.za 1.

188 ibid.

189 (n 13) 9-10.

190 Greenstein and Vasarhelyi *Electronic Commerce* (2002) 1-3 define electronic commerce as: "(t)he use of electronic transmission mediums (telecommunications) to engage in the exchange, including buying and selling, of products and services requiring transportation, either physical or digitally, from location to location." E-Business represents a wider concept which does not limit itself to "…the exchange of information directly related to the actual buying and selling of goods."

191 Scott "Good governance is good business, says King" (last visited 20 August 2002) http://www.itweb.co.za 1.

(i) An effective performance measurement system must be in place.[192] The balanced scorecard approach to performance measurement may successfully be employed here;

(ii) Effective monitoring and reporting mechanisms must be in place, which are forward-looking, accurate and precise;[193]

(iii) Accountability towards shareholders and stakeholders plays an essential role in any company;[194] and

(iv) Transparency and disclosure of material information to all relevant parties are of pivotal importance.[195]

The King II report identifies six areas where information technology will inevitably impact upon corporate governance, namely:

(i) Internal control systems

The responsibility to ensure that an effective system of internal controls are in place, monitored and reviewed on a continuous basis is vested in the directors of the company.[196] It is furthermore required of management to ensure that an effective control environment is being maintained.[197]

(ii) Reporting

Information technology should be used to improve transparency and reporting.[198] Information sharing will play a pivotal role in the new economy.[199] It is contended by the report that information technology makes communication with stakeholders much easier, and may be

[192] ibid.
[193] ibid.
[194] ibid.
[195] ibid.
[196] (n 13) 138.
[197] ibid.
[198] (n 187) 1.
[199] (n 187) 3.

used to convey important information using the company's web site or e-mail facilities.[200]

(iii) Fiduciary implications

The report acknowledges that with the advent of the information age laws, regulations and standards will have to be revisited and in some cases even amended in order to facilitate the broader scope information technology has introduced into the business world.[201] It goes on to identify certain shortcomings in present legislation, for instance the electronic formation of contracts, direct and indirect taxation, acknowledgement of receipt, and numerous other contentious issues.[202] Fortunately the newly enacted Electronic Communications and Transactions Act[203] provides organisations with legal certainty and statutory backing on most of these issues.[204]

Furthermore the responsibility is placed on the shoulders of management to ensure that employees possess over the necessary skills and expertise to administer and monitor information technology.[205] Information technology is a very complex issue that is constantly changing and evolving.[206] It is therefor expected of top management, the board and the employees who were designated to work with information technology, to keep informed of the latest developments in this field.

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200 (n 13) 138.
201 (n 13) 139.
202 ibid.
203 25 of 2002.
204 The Electronic Communications and Transactions Act 25 of 2002 gives legal certainty on issues pertaining to, for instance: (i) online contracting by means of communication of data message (chapter three); (ii) consumer protection (chapter seven); and (iii) the protection of personal information (chapter eight).
205 (n 187) 2.
206 ibid.

It is contended by Conger et al[207] that boards are much more qualified to deal with the challenges facing them in the information age than their counterparts of a generation ago. They advance the following reasons for this statement: (i) boards play a much more active role than in the past; (ii) board are more powerful, because of the involvement of independent auditors and non-executive directors; and (iii) they give regard to monitoring and reporting on not only the organisation's performance, but also on their own performance.[208]

(iv) Business

The report recognises that e-commerce has in fact changed the way in which business is being conducted.[209] Inevitably this impacts on the legal system, as organisations will now have to conduct an introspection into their own business practices. The report furthermore makes a monumental breakthrough by recommending that companies that engage in e-commerce have to ensure that their business partners comply with sound governance practices.[210] The reason for this being that the information age has wiped out any and all territorial boundaries that existed previously.[211] Governance is therefor no longer confined to the boundaries of one company or group of companies, but must be viewed widely across the supply chain.[212] This recommendation has placed an onerous burden on companies. Not only will they have to evaluate their own governance practices, they

207 (n 2) 124.
208 ibid.
209 (n 13) 139.
210 (n 187) 1.
211 ibid.
212 ibid.

will also have to investigate the degree of compliance with governance principles of other companies they want to do business with.[213] In effect one company may refuse to do business with another because it is not considered to be a "good corporate citizen" by not adhering to a satisfactory level of corporate governance practices.[214] Organisations might be faced with situations where companies offer the same or similar products and/or services, where the one illustrates better governance practices than the other. The former might be chosen above his competitor as a result of this.[215]

(v) Technology

The report argues that because of the profound influence of technology, and specifically information technology on the business environment, the concept of "governance" will be accentuated in order to satisfy stakeholders.[216] The report goes on to argue that because of the complexities associated with information technology, and the danger that stakeholders might have a preconceived idea that information technology companies will display enormous growth in the future, managers will have to be honest and transparent when educating stakeholders and employees on what the concept of information technology within their business environment entails.[217] This will include disclosing the benefits to be reaped by effectively making use of information technology as well as the potential exposure to risk, vulnerabilities and threats associated with information technology.[218]

[213] ibid.
[214] (n 187) 2.
[215] ibid.
[216] (n 13) 139.
[217] (n 13) 140.
[218] ibid.

(vi) Cost/value relationship

It is expected of managers to pay attention to the cost/value relationship of its information technology strategy. The weighting of different interest must occur before an acceptable balance can be found.

In summary the King II report places a duty on directors to ensure information technology is:

(i) Used within the organisation to obtain a sustainable competitive advantage;[219]

(ii) Information technology must enable, support and be aligned with the organisational strategies;[220]

(iii) Directors are expected to fully understand what the purpose of information technology within their organisation is; and[221]

(iv) Must oversee the implementation of information technology within the organisation.[222]

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3.5 Conclusion

> "If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises in that country – regardless of how steadfast a particular company's practices may be – suffer the consequences. Markets must now honor what they perhaps, too often, have failed to recognise. Markets exist by the grace of investors. And it is today's more

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[219] Info Sec Africa press release "Alignment of business and IT strategy using the balanced scorecard" (last visited 20 August 2002) http://www.itweb.co.za 1.

[220] ibid.

[221] ibid.

[222] Criticism launched against King II is that it does not go far enough in emphasising the importance of information technology within the business environment. Another problem that arises is one of flexibility and agility. Because of the fact that organisation's spent a long time refining their governance mechanism to best suit their needs and deliver on the expectations of stakeholders in the current market, they find it very difficult to adapt and respond quickly to new changes. Research have shown that organisations that were business leaders in one technology almost never succeed in being leaders when the next technological breakthrough occurs. In most cases the sole element responsible for this is organisational inflexibility.

> empowered investors that will determine which companies and which markets will stand the test of time and endure the weight of greater competition. It serves us well to remember that no market has a divine right to investors' capital."[223]

Governance is concerned with "leadership with integrity, responsibility and transparency."[224] This obligation has gained a new meaning with the dawning of the information age. In the past the governance obligation was mostly limited to the financial arena, but at present organisations are beginning to realise governance is a multifaceted discipline that extends over the organisation as a whole.[225]

The information age and continued technological developments offer significant advantages to organisations.[226] Some attributes of the information age include ease with which information and data are able to flow across borders, the low cost associated with the transmissions of data/information, increased speed of communications, flexibility and interconnectivity, which enables individuals and global conglomerates alike to be connected to the world by the "click of a mouse."[227] The negative side to this borderless environment is that the organisation is inevitably exposed to a growing number and greater variety of risks, vulnerabilities and threats. Consequently the discipline of information security governance has evolved in direct response to the new information society's demand for greater understanding of security issues, the need to develop a culture of security and the ever changing security environment.

After having gained a basic understanding of what the two separate concepts information security and governance entail. We may now proceed to investigate the legal implications of the overall information security governance discipline, by first of all addressing the question: "who should concern themselves with information security governance, and why?"

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223 Statement made by Arthur Levitt, former Chairperson of the US Securities and Exchange Commission.
224 (n 19) 1.
225 Bidoli "Directors, beware" (last visited 6 April 2002) http://www.futurecompany.co.za/cgi-bin/pp-print.pl 1.
226 ibid.
227 ibid.