Corporate Governance Structures: The Balancing Act Performed by South African Financial Services Companies.

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I acknowledge that, other than as specifically referenced, this work is entirely my own and that the references given are accurate.

Signed

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Background

1.1. **Introduction**

The term "corporate governance", as is pointed out by Keasey, Thompson & Wright (1997), was rarely encountered before the 1990s. In more recent times the concept has frequently appeared in the media and has been the topic of numerous committees of enquiry in various countries all over the world, including South Africa. The authors, referred to above, also make the point that the concept defies precise definition because of the differing opinions over the problems encountered by the modern company. Ultimately it is the existence of numerous stakeholders in the company, with differing levels of power and influence, which results in the need for formal structures and policies to balance stakeholder interests. In adopting such "balancing structures" the following questions arise. For what end should this 'balancing act' be done? What is the ultimate objective and which stakeholder is ultimately the king?

The purpose of this dissertation is to provide the reader with a clear understanding of the concept of corporate governance and what the individual rules of this 'balancing act' are meant to achieve.

This is accomplished by, in the first chapter, referring to academic research on the reasons for the development of the corporate governance concept. Four "models of corporate governance" are described in this section. These "models" serve as a framework for the evaluation of the second *King Report on Corporate Governance for South Africa* (for convenience referred to as *King II*), which was published in March 2002. This first chapter also provides a short overview of the *King Report on Corporate Governance for South Africa 1994* (Henceforth referred to as *King I*). The discussion of *King* I, serves to illustrate the beginnings of corporate governance in South Africa. In the second chapter, the focus shifts to the contemporary corporate governance structures and mechanism, which are aimed at ensuring good governance in modern corporations.

The second chapter includes a review of the existing research on governance structures and mechanisms, and whether or not these have been successful in the United Kingdom. The reader will find that the research is often at odds as to whether governance structures actually serve their intended purpose. This chapter also provides a detailed overview and evaluation of governance structures proposed by *King II.* This overview will highlight the development of corporate governance since the publication of the *King I* and places the final report in a philosophical context, linking to the discussion in chapter 1.

In the third chapter provides an analysis of a sample of companies listed on the Financial Services sector of the Johannesburg Stock Exchange and the extent to which these companies are managed in line with contemporary governance structure requirements. This research demonstrates that although the companies are managed in accordance with *King I*, recommendations, *King II* provides additional "challenges" to these companies. These challenges are elaborated on in chapter four which is a further evaluation of *King II* given the academic research referred to in chapter two and the current reality represented by the sample of companies referred to in chapter three.

The fifth and final chapter consists of recommendations for improved governance, further research and a conclusion of the dissertation. The author is of the ultimate view that stakeholder education and additional publicity around corporate governance is key to ensuring that the rules of the "balancing act" are adhered to at all times. The overall conclusion is that an independent rating agency is required in South Africa to publicly rank companies on their compliance to good corporate governance standards.

1.2 Reasons for Corporate Governance

One could, in very broad terms, trace the concept of corporate governance to the separation of powers between the owners and the management of the corporation. Blair (1995), for example, has suggested that the current differing perspectives on corporate governance are directly related to the fact that theorists disagree greatly over the actual significance of this separation power between management and the owners. Blair has accordingly identified four competing views on the problems associated with corporate governance and how to improve governance in companies. An understanding of these four views will contribute to a greater appreciation of the concept of corporate governance.

1.2.1. The Agency Model

The first of these views or models, the Principal –Agent or Agency Model, is grounded on the premise that markets are efficient and that the role of the corporate manager should be maximize shareholder value. Proponents argue that the efficiencies in the markets for capital, managerial skills and corporate control create the best restraint on managerial discretion. In terms of this model the shareholder voting rights are sufficient to ensure that management employ their resources efficiently and in the best interests of the company. Leveraged and management buy–outs, hostile take over bids and executive share options are all market developments aimed at ensuring that the interests of shareholders are upheld by management. Supporters of this model acknowledge that corporate governance failings do occur, but suggest that the factor market and the market for corporate control best address these failings. Any restrictions on these markets create inefficiencies and do more harm than good. Supporters of this model are generally in favour of the introduction of a voluntary code of corporate governance but would object to any legislative interventions (Blair, 1995).

The separation of ownership and control and the resultant costs associated with the monitoring of the conflicting rights and obligations is referred to by Fama and Jensen (1983a) as giving rise to "contracts or internal 'rules of the game' (which) specify the rights of each agent in the organization".

The establishment of 'rules of the game' to ensure that shareholder interests are promoted is, in terms of the Agency Model, the purpose of corporate governance. This objective is also well defined in the definition adopted by, Dockery (2000) as follows:

> "An important objective of corporate governance is securing accountability of corporate management as shareholders' agents who are provided with authority and incentives to promote wealth-creating strategies." (p. 21).

This definition is relatively narrow in its view of the responsibilities of management. The Agency Model, as will be demonstrated in chapter two, is also far narrower in its underlying philosophy than that which has been adopted by *King II*.

This distinction also serves as a basis on which to distinguish the approach, which was adopted in the United Kingdom, albeit in the 1990s, to that which is currently followed in South Africa.

1.2.2. The Myopic Market Model

The Myopic Market Model looks at the need for corporate governance entirely differently. It suggests that the market is not entirely efficient in its valuation of companies' long-term expenditure (such as R & D and capital investment). This, it is argued, forces managers to drive short-term interests above long-term objectives in their bid to provide shareholders with an adequate return. The role of corporate governance in this model is thus to align the shorter-term interests of management with the longer-term wealth maximizing interests of shareholders.

In terms of this model market inefficiencies drive the need for corporate governance, the divergence of shareholder and management interests are a consequence of the market inefficiency.

Supporters of this model are in favour of reforms, which would reduce the ability for shareholders to exit the company as they have a responsibility of keeping management in check. In addition to this, the model seeks to encourage long-term relationships between all stakeholders and to restrict the voting rights of short-term investors. The takeover process should also be restricted. This model thus advocates reforms that the principal agent model is adamant should be avoided.

1.2.3 The Abuse of Executive Power Model

The abuse of executive power model holds that the division between corporate ownership and control results in an excess of power being vested in management, some of whom are inclined to abuse this power and promote their own interests to the detriment of the company. According to this model the institutional restraints on managerial power are insufficient to prevent managerial abuse of power. This theory has received support recently from a study conducted by Kay and Silberston (1995) who argue that the majority of listed companies are managed by a board, which is a self-perpetuating oligarchy. These authors have compared the senior management of listed companies to the governing elite of political dictatorships. Kay and Silberston (1995) therefore, argue for legislative intervention in order to limit the powers of senior management. They support the statutory limitation of the term of office of the chief executive officer and legislation that would ensure the independence and power of the non-executive director.

1.2.4. The Stakeholder Model

The Stakeholder Model's central theme is a direct challenge to the Agency Model. Its central theme is that the role of the corporation should be far broader than the maximization of shareholder wealth. Instead the corporation should have the interests of all long-term stakeholders at heart. These stakeholders include: customers, suppliers, employees and society. The role of corporate governance should be to ensure that the interests of all stakeholders are balanced and that there is no long-term domination by any one of these stakeholders.

Although the philosophy of this theory is a challenge to the Agency Model, which has the promotion of shareholder wealth as its central tenet, Hill & Jones (1992) have suggested that a more inclusive approach may not actually be at odds with a shareholder focused model. In terms of their view the Stakeholder Model would be complementary in nature to the Agency Model. (One may think of this as a Stakeholder-Agency Model).

The underlying premise of the Stakeholder Model is that if due consideration and the ethical treatment of **all** long term stakeholders is the best strategy to ensure long term profits, then the shareholders should encourage managers to follow this strategy. Such a strategy would then, by definition, also be in the interests of shareholders and lead to the creation of long-term shareholder wealth. The following definition of corporate governance, which is taken from a recent *World Bank Report*, reflects the philosophy of the stakeholder model:

> "Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals...the aim is to align as nearly as possible the interests of individuals, corporations and society." (Cadbury, 1999).

The most recognized public contributions to the topic of corporate governance in the South Africa have undoubtedly been the reports of the *King Committee on Corporate Governance for South Africa*. The focus of this dissertation will be devoted to these reports.

1.3. *King I* - In the Beginning

This section is aimed to provide an overall background context, specifically, to corporate governance in South Africa and to identify whether South African recommendations on corporate governance issues have differed from those in the United Kingdom. This will, ultimately, serve to provide an understanding of how corporate governance has developed since 1994 to the publication of the second *King Report on Corporate Governance for South Africa*, in 2002.

The *King Report on Corporate Governance for South Africa* was first published in 1994. This report followed shortly after the *Cadbury* report (1992) in the United Kingdom. In the United Kingdom, the *Cadbury* report and various other related reports were later combined to form, what is now known as, the *Combined Code on Corporate Governance*. The Combined Code is now an annexure to the London Stock Exchange Listing Rules and listed British companies are required in their annual financial statements to indicate the extent to which they have complied with the Combined Code during their accounting period. (Gronow, 2001). *King II* was published in March 2002; this study aims to focus predominantly on *King II* and to evaluate this in terms of the research, which has been conducted on corporate governance by various academic writers.

The media attention paid to the topic has resulted in a fair degree of debate as to what exactly is meant by corporate governance. The difficulty in defining corporate governance is also linked to the differing opinions on its purpose, as discussed in section 1.2 above. Keasey and Wright define corporate governance as the concerning "the enhancement of corporate performance via the supervision, or monitoring, of management performance and ensuring the accountability of management to shareholders and other stakeholders." (1997, p.2).

A reading of the founding statement of the Cadbury report (1992) also provides some insight into the purpose and need for corporate governance measures. The Cadbury Committee was set up due to the concerns of the sponsors at the "perceived low level of confidence both in financial reporting and in the ability of auditors to provide the safeguards, which the users of the company reports sought and expected." (Cadbury, 1992, p. 14). In terms of this report corporate governance was defined as "the system by which companies are directed and controlled." (Cadbury, 1992, p.15).

The above purpose distinguished this report from both King reports in that the Cadbury report focused primarily on financial governance issues as opposed to the broader corporate governance concerns.

Not surprisingly, the mandate of the *King I* was much wider than that of Cadbury. With the democratization of the South Africa the King Committee also had to take account of special circumstances, particularly the emergence of a new class of entrepreneur in previously disadvantaged communities (King, 1994). Referring to the Cadbury report, the following extract from *King I* reflects not only the broader mandate but also the recognition of the significance of multiple stakeholders in business:

> "The Cadbury recommendations involved the financial aspects of corporate governance and focused on integrity and shareholder dominance. While it is of the utmost importance that companies operate form a base of integrity, we believe that the focus must be on a participative entrepreneurial approach rather than a dominant one" (King, 1994, p.5).

The South African context, at the time, thus distinguished this first report from similar reports in the United Kingdom in that the role of enterprise was given more emphasis in South Africa. This was often referred to by the committee and clearly influenced the recommendations.

In the following sub-sections an overview will be provided of the governance structures recommended by *King I*.

1.3.1. Board Structure

The first King report recommended that the board of directors should consist of at least an equal number of executive and non –executive directors. It was also recommended that the chairman should be a non –executive director.

The committee also considered the benefits of a two-tier board structure but rejected this due to the expense of such a structure and the opinion that the unitary board structure was able to achieve the objectives of a two-tier board structure.

It was also recommended that the board should meet at least quarterly.

1.3.2. The Non –executive Directors

This category of director was defined as a director who is not an employee of the company involved in the day-to-day management of the business. The King Committee went on to specify that the non–executive director should be independent and could therefore not be a member of the company pension fund or medical aid fund to which the company contributes. The committee recommended that each company should have a minimum of three non –executive directors including the chairman. It was further felt that such directors should not be appointed for a specific term but that the tenure should be dependant on the performance of the individual and thus at the discretion of the board. The committee referred to directors serving a “silent apprenticeship for six months to one year” before actively participating in board activities (Ibid, p. 12).

King I did not elaborate on the requirement of independence for non-executive directors. The *Cadbury* report by contrast, defined independence as follows:

> "..apart from their directors' fees and shareholdings, they should be independent of Management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment" (Cadbury, 1992, p.22).

King I listed four important functions of non –executive directors,
Firstly that they should "bring their special expertise and knowledge to bear on the strategy, enterprise, innovative ideas and business planning of the company" (King, 1994, p. 6). Secondly, the responsibility to monitor and review the performance of the executive management. Thirdly, the role of resolving conflict of interest situations, for example those involving executive remuneration, succession and hostile takeovers. Finally, they function as a check and balance to the executive directors (Ibid, p.6).

The *King I* recommendations should be seen in the unique South African context of 1994. This context was one of a new democracy eager to enter the world stage yet facing a serious shortage of skilled labour. In certain places one may question wisdom of the inclusive approach adopted by *King* I. An example of this is the concept of an "apprenticeship", as it is referred to and discussed in the recommendation. The apprenticeship requires newly appointed directors to merely observe boardroom practices as opposed to actively participating in debates and discussion. Where one has an equal number of executive and non –executive directors a silent "apprentice" non –executive director would result in the dominance of the executives. In addition to this the committee referred, in earlier paragraphs (p.11), to South African company law and stated that, in relation to fraud or negligent and reckless conduct, non-executive directors and executive directors would be held equally accountable to shareholders. The silent apprentice, it is submitted, would not be able to rely on an apprenticeship as a defense for his failure to exercise corrective action where such was needed. This has been omitted from King I.

1.3.3. The Chairman and CEO

The committee recommended that it was preferable that the role of chairman should be separated from that of Chief Executive Officer. The conclusion reached by the committee was that the chairman should be an independent and non –executive director. The committee recognized that in many instances, due to the skills shortage in South Africa, the separation of the roles would not be possible. It was suggested that where this was the case the non-executive directors would have an added responsibility to ensure that the chairman was supportive of proper deliberation and that he encouraged debate.

1.3.4. Remuneration Committees

King I was in favour of the appointment of remuneration committees consisting of a non-executive chairman and a majority of non-executive directors. This recommendation may be contrasted with that of the *Cadbury* (1992) and *Greenbury* (1995) committees. *Cadbury* called for remuneration committees comprised mainly or wholly of non–executive directors, while *Greenbury* took this a step further by stipulating that such committees should consist only of non-executive directors.

1.3.5. Nomination Committees

The *King I* report stated that the committee was opposed to the institution of nomination committees because it felt that the entire board should be involved in the appointment of directors. The committee also questioned the practicality of recommending a nomination committee consisting of non –executive directors in a South African environment characterized by a skills shortage.

The committee went on to recognize that the selection process in the past had often been wrong and that this had lead to a lack of diversity in board appointments, in terms of both race and gender.

Although the importance of "the courage to express…independent thought" (King, 1994, p.15) is referred to by the committee there was not much recognition of the benefit of diversity of thought which often accompanies diversity of race, culture, ethnicity and gender.

1.3.6. Audit Committees

The *King I* recommended that all listed companies should have audit committees. It was further recommended that these committees should be chaired by a non-executive director and should consist of, at least one other and preferably, a majority of non-executive directors. It was also recommended that the financial director, external and internal auditors should attend all audit committee meetings. The committee also voiced the view that the membership of the audit committee should be published in the annual report of the company.

It is interesting to note that the publication of the membership of this committee was a specific recommendation and that no similar recommendation was made for the remuneration and nomination committees.

1.3.7. Compliance to *King I* in 1995

Pullinger (1995) conducted research into the acceptance of the Cadbury Committee recommendations amongst the *Financial Mail Top 300* South African companies and a sample of financial services professionals. Although the research was conducted prior to the actual publication of *King I* it is interesting to note that it was found that the majority of respondents were broadly in favour of the *Cadbury* recommendations. It was found however that the actual compliance to *Cadbury* (the British code), by the sample of South African companies, was relatively low. Only 40.3% of respondents, for example, had a non-executive chairman while only 50.8% confirmed a separation of the roles of chairman and CEO. In terms of overall board structure only 62.9% met the requirement of a minimum of three non-executive directors.

Pullinger's research into the governance of director remuneration revealed even lower compliance to Cadbury. Only 29.8% of respondents reported having a remuneration committee, made up wholly or mainly of non-executive directors, in order to make recommendations on executive's remuneration. Not surprisingly an even lower percentage (9.7%) of respondents confirmed that the composition of their remuneration committees were be disclosed in the directors' reports.

Although the above research by Pullinger was conducted before the publication of *King I*, a tabular analysis (see table 2.3.7) of the *Cadbury* recommendations and those ultimately published in *King I*, reveal that the requirements were very similar. The statistics quoted in Pullinger's research are thus relatively accurate in measuring compliance to *King I* in 1995.

The research conducted by Pullinger in 1995 has contributed to the motivation to establish, from current research, the extent to which a small sample of South African companies are in compliance with *King II*, which has set standards even higher than those set by *Cadbury* and *King* I almost a decade ago.

1.4. Motivation for the Study

The main motivation for this study is the need to understand corporate governance both at a practical level and in terms of academic research. Initial interest was sparked by the high profile given to corporate governance issues both locally and in the international environment. The corporate failures of local companies such as, Regal Treasury Bank Ltd (2001), Saambou Bank Ltd (2002), Unifer Ltd (2002), Fedsure Ltd (2001) and Leisurenet Ltd (1999) have placed corporate governance issues in the limelight. This has also occurred in the international environment with the recent collapse of Enron (2001) in the United States and the conviction of the accounting firm Andersen Consulting for not fulfilling its functions as an auditor of the firm.

Unfortunately it is the researcher's impression that the South African media have been very quick to "jump on the corporate governance bandwagon" in an attempt to increase circulation without providing the reader with a clear understanding of the topic.

In addition the media coverage devoted to the publication of the second King Report in March 2002, had not paid any attention to academic research conducted into corporate governance, particularly the structures, and the extent to which these have been scientifically tested in order to establish whether they have been successfully employed in other countries.

There also appears to be very little published academic and business research on corporate governance in South Africa. Certainly there is less than that, published in the United Kingdom and United States.

1.5. Objectives of the Study

The purpose of this study is to conduct qualitative research into the topic of corporate governance in order to obtain a clear understanding of the topic. This research will thus investigate the development of corporate governance in South Africa since the introduction of the first *King Report on Corporate Governance* in 1994. Once the objective of gaining a thorough understanding of corporate governance structures has been achieved, the objective is to practically test the extent to which these structures are employed in a small sample of companies listed on the South African financial services sector of the Johannesburg Stock Exchange. This last part of the study is focused on specific elements of corporate governance including the following:

- Structure of the Board of Directors
- Separation of the Roles of Chief Executive Officer and Chairman of the Board
- The Existence and Structure of Audit Committees
- The Existence and Structure of Remuneration Committees
- The Existence and Structure of Nomination Committees
- The Existence and Role Played by Institutional Shareholders.

The practical study referred to involves six listed financial services companies. The companies were selected on a convenience-sampling basis and excluded the five large South African banks. The aim of the this study is to determine the extent to which the companies selected had governance structures in place, which complied to the second King report, although this had not yet been published.

1.6. Limitations of Study

This is a qualitative research study into the corporate governance structures generally and a investigation the structures employed by a small sample of companies listed in the Financial Services Sector of the Johannesburg Stock Exchange. The findings are limited to the selected sample of companies as the sample is small and a convenience based sampling strategy was employed. The study is also limited in the sense that the governance structures of the sample companies are investigated over a relatively short period, namely three years. Above limitations aside, the study provides a valuable analysis of contemporary South African corporate governance structures and draws comparisons to those that have been recommended in the United Kingdom by the *Cadbury Report*.

1.7. Structure of Study

The second chapter provides a review of the existing research on governance structures and mechanisms, and whether or not these have been successful in the United Kingdom. In this chapter, the author also provides a detailed overview and evaluation of governance structures proposed by the second *King Report on Corporate Governance for South Africa* (for convenience referred to as *King II*), which was published in March 2002. This overview highlights the development of corporate governance since the publication of the *King I*. It will also serve to place the final report in a philosophical context, linking to the discussion in chapter 1.

The third chapter will provide an analysis of a sample of companies listed on the Financial Services sector of the Johannesburg Stock Exchange and the extent to which these companies are managed in line with contemporary governance structure requirements.

The fourth chapter will provide a further evaluation of *King II* given the academic research referred to in chapter two and the current reality represented by the sample of companies referred to in chapter three.

The fifth and final chapter will consist of recommendations for improved governance, further research and a conclusion of the dissertation.

1.8. Summary

There are four models proposing different reasons for corporate governance. These are the Agency Model, which favours shareholders; the Myopic Market Model, which regards the capital market as inefficient in its valuation of companies; the Abuse of Executive Power Model, which has a "directors' watchdog view" of corporate governance and the Stakeholder Model, which seeks to balance the interests of all stakeholders. These models may serve as a means of understanding the actual objectives of corporate governance and are not necessarily at odds with one another. The objectives of *King I* were to ensure that all stakeholders' interests are given sufficient recognition by management of the company. The governance structures recommended by *King I* were designed to take into consideration South Africa's burgeoning democracy and the need to encourage enterprise.

The following chapter will provide an overview of the governance structures recommended by the second King report.

Chapter 2
King II and Corporate Governance Structures

2.1. Introduction

The objective of this chapter is to provide, both a context to, and clear understanding of, the second *King Report on Corporate Governance for South Africa* (2002). This is achieved by firstly identifying the underlying philosophy of *King II,* in terms of the models adopted by Blair (1995), referred to in section 1.2. The second part of this chapter will create a time related context by identifying the developments, in this report, which have taken place since the publication of the first *King Report on Corporate Governance for South Africa* in 1994. This should give the reader an understanding of the direction in which South African corporate governance is moving. The final part of this chapter will be devoted to an overview of the actual governance structures recommended by *King II.*

The overall intention of this chapter is to provide a basis from which to evaluate the existing structures adopted by the sample of financial services companies selected by the author and to be able to critically evaluate the recommendations of *King II*, against the research literature which has been discussed in chapter one and the structures adopted by the sample of companies. The critical evaluation will be conducted in chapter four.

2.2. The Philosophy of *King II*

Reference was made in chapter one, in comparing the mandate of *King I* to that of *Cadbury,* that the mandate of the former mentioned was to consider far broader groups of stakeholders than the shareholders. This "multiple stakeholder" philosophy has been continued and expanded upon by *King II*. This broader consideration of all stakeholders is found in *King II* making extensive recommendations on triple bottom line reporting. In fact, the most recent King Report goes far further than its UK predecessors by, not only recognizing all stakeholders but, also acknowledging the cultural context of the corporate governance regime. The African context is recognized in section four of the report, which is devoted to "Integrated Sustainability Reporting". This section has chapters on; "Stakeholder Relations", "Safety, Health and the Environment" and "Social and

Transformation Issues" including Black Economic Empowerment. The section is commenced with the well-known African proverb: " '*Umuntu ngumuntu ngabantu*' (I am because you are, you are because we are.)" which clearly reveals an understanding of the South African context in which the recommendations have been made (King, 2002, p. 91).

It is thus clear from an overall reading of the report that the model adopted by *King II* is a Stakeholder based model. The report places great emphasis on the means by which good corporate governance will be enforced. There is, within this context, a significant role for an internal audit department in monitoring the company's adherence to good governance principles. Section 6 of the report is devoted entirely to "Compliance and Enforcement". This illustrates that the recommendations made in the report have not merely been set as 'isolated guidelines;' the committee has actually paid attention to ways in which they can be enforced. This is a bold step and a significant departure from corporate governance codes in other countries.

The philosophy adopted by *King II* is also in keeping with the *Principles For Corporate Governance in the Commonwealth* (1999). The Commonwealth corporate governance guidelines adopt what is referred to as an "inclusive approach" (1999, 3). In addition to this the guidelines specifically refer to the danger of corporate governance principles stifling "or being at the expense of enterprise and profitability" (1999, 4). Although this issue has not received much emphasis in *King II* the theme was clearly emphasized in *King I*. The inclusive approach adopted by *King II*, it is believed, is sufficient to recognize the specific needs of South Africa, a developing African country, with the needs to promote high levels of corporate integrity, such that it is able to attract valuable foreign investment, and at the same time promote entrepreneurial spirit.

2.3. The Transition from *King I* to *King II*

The period between the publication of *King I* in 1994 and *King II* in 2002 is characterized by a rapid growth in information technology and the accompanying collapse of the so called "dot –com" companies all over the world. The intervening period has also seen the democratization of South Africa and an increased accessibility of the country to global markets and foreign investment. The period has also seen the introduction of a great deal of legislation aimed at restoring the inequalities of the past. The above socio-political issues have contributed to the adoption of a broad stakeholder based governance regime, which balances the need for enterprise with the socio-political needs of South Africa. It is also worth noting that the 'lack of sufficiently skilled people' to assume directorships, which was used as an excuse to temper the recommendations in *King I*, has been dropped from *King II*. In fact, the following statement is made in *King II (2002)*:

> "The perceived lack of available and sufficiently experienced directors in our economy should not be a reason or excuse for boards to seek to constitute the majority of their non-executive directors as individuals independent of management and the company" (47, 3).

There is also the realization that for South Africa to be internationally competitive the standard of governance needs to be world class. There is reference in *King II* to a McKinsey & Co. *Investor Opinion Survey* which established, in June 2000, that 84% of global institutional investors were willing to pay a premium for the shares of a company characterized by good governance over a financially comparable company with less satisfactory governance (2002, p.13). In emerging countries, which were perceived to have, generally, poor governance practices this premium was found to be as high as 22% to 27%.

Evidence of the effect of international competition and acceptance of the benefits of a good governance regime is found in the trend of large South African corporations such as Old Mutual Plc, Anglo American Plc, South African Breweries Plc and Didata Plc deciding to select the London Stock Exchange (LSE) as their primary listing. Although these large companies may have been motivated primarily by their need to raise foreign capital, the fact that the LSE has an extremely progressive corporate governance code must have played a positive role. This may have been a dual role in that it would attract both investors (representing capital) and large corporations who realize that good governance and friendly capital markets keep the same company.

The international competition, thus contributed to *King II* paying more careful attention to the requirement of independence on the part of non-executive directors and devoting an entire section, comprising eight chapters, of the report to "Compliance and Enforcement" (King, 2002, p.142). The report currently represents the most progressive and inclusive corporate governance code in the world.

The general South African regulatory environment has also gone through huge transformation over the period in question in order to meet international standards. Amongst other developments:

- The listing requirements of the Johannesburg Stock Exchange were improved in 1995 and 2000,
- Recommendations for statutory amendments contained in *King I* were included in the Companies Act 61 of 1973.
- The Insider Trading Act was promulgated in 1998,
- And numerous amendments were brought about to the Banks Act 90 of 1990 in order to enforce stricter governance practices for banks. In 2000 for example it became mandatory for banks to have a non-executive as chairman of the audit committee.

The approach adopted by *King II* is also characterized by the belief in "regulation by the adoption of the philosophy of disclosure" (2002, p.147). As will be discussed later, with reference to academic research conducted in the United Kingdom, this philosophy may not actually "deter the incidence of malpractice and excessive executive rewards" (2002, p.147).

Inspite of, what may amount, in the above, to the over-emphasis of disclose as a means of "justifying" corporate managerial behaviour, *King II* has made a significant positive contribution to South African corporate governance. This has not only been achieved in the substantive detail of the report but also in the way in which the report was constructed in that the draft report was published in July 2001 when public comments were invited with the final report making its appearance in March 2002.

Table 2.1

Comparison of Corporate Governance Codes

	King I	King II	Cadbury Report	Hermes Investment Management
Board Structure	Equal number of executives and non-executives. Chairman should be a non-executive. Minimum of two NEDs. Directors should not have a specific term of office. Office at discretion of board. Silent apprenticeship for new directors.	Majority of Non –executive members with sufficient independent directors. Chairman should be independent NED. No specific term of appointment of NEDs. Executive director service contract not to exceed 3 years. Board to meet at least once a quarter.	Board should consist of a minimum of 3 NEDs. Of these the majority should be independent. Appointment for a specified term. No service contracts for more than 3 years without shareholder approval.	Boards should consist of a strong core of independent NEDs. The ratio of executives to NEDs is for the board to determine with shareholder approval. NEDs service contract not to exceed 10 years. Directors to have one year rolling contracts. One new NED to join board every 3 years.
Chairman & CEO	Should be separate, unless justification for combining exists.	Should be separate	Should be separate.	Should be separate. Is also against CEO becoming chairman in the same company.
Audit Committee	Comprise at least two NEDs. Meetings include financial director, external audit partner and internal audit.	Minimum two independent NEDs, chairman to be independent non – executive and not the chairman of the board.	Minimum of three members, confined to NEDs of which the majority should be independent.	No comments on this sub- committee appear in code.
Remuneration Committee	Should advise on non –executive & executive remuneration. No separate disclosure of remuneration only executive & non-executive split.	To consist entirely or mainly of independent NEDs	To consist wholly or mainly of independent NEDs. Disclosure of chairman & highest paid director's remuneration.	To consist of only independent non-executives. Remuneration report should be put to vote at AGM. Remuneration to be aligned to shareholder returns.
Nomination Committee	Not recommended appointment of directors a matter for entire board consideration.	Only NEDs, of which independent directors should be majority. Chaired by board chairman.	Majority of NEDs under chairmanship of chairman of the board or independent NED.	To comprise minimum of three directors. Majority should be independent. Chairman of board & senior independent NED should always be members. Chairman of committee should be NED.

(Note: NED refers to non-executive director)

2.4. Evaluation of *King II* Corporate Governance Structures

This section provides an evaluation of *King II* in terms of academic research on the topic of corporate governance. The evaluation is also comparative in nature in that the recommendations in the codes referred to in table 2.1 above are compared to those of the *King Committee*. The evaluation focuses, mainly, on the governance <u>structures</u> recommended by *King II* (2002) and those recommended by *Cadbury* (1992).

2.4.1. Composition of the Board

In the *Code of Corporate Practices and Conduct* contained in *King II* (2002) it is recommended that:

> "Companies should be headed by an effective board that can both lead and control the company. The board should comprise a balance of executive and non-executive directors, preferably with a majority of non-executive directors, of whom sufficient should be independent of management so that shareowner interests (including minority interests) can be protected" (2002, 23-24).

The report goes on to recommend that the appointment of directors should take place in a transparent and formal process. This appointment process, it is recommended, should remain the responsibility of the board as a whole and, where appropriate, take place with the assistance of a nomination committee (2002, 24).

With regard to the composition of the board the report goes on to call for the staggered rotation of board members and emphasizes the importance of continuity for the board. The staggered rotation by board members is not discussed in much detail. It understood to mean that directors should remain in office but hold varying portfolios over their period of tenure. If this interpretation is correct this far short of the drastic recommendation adopted by *Hermes Investment Management* (2001) which calls for the rotation of non-executive directors on the basis of the exit and replacement of at least one director every three years. (Table 2.1 above provides are more detailed comparative analysis of the *King II* and *Hermes* recommendations).

King II, it is submitted, has correctly identified the crucial considerations in board composition, which are to; balance the introduction of diversity, ensure independent and fresh thinking <u>and</u> the need for smooth continuity. It is submitted that to create a board which varies too frequently in its composition would in fact be harmful to good governance. This would certainly be the case if one where to apply the principles of the Agency Model which emphasizes the control aspects associated with access to information and particularly the imbalance that exists in this regard between executive, and non-executive directors and shareholders on the other hand.

King II has distinguished between three classes of directors.

Firstly, the class of the executive director. This class comprises those directors who are involved in the day-to-day management of the enterprise. Such directors are usually full time salaried employees of the company or one of its subsidiaries. Secondly, the class of non-executive director that would consist of those directors who are not in the employment of the company and are not involved in the day-to-day management of the company. Non-executive directors would include those individuals who are employees of a holding company of the company concerned. The category would also include those individuals who are employees of a sister company of the company concerned. Finally, the class of independent director. This class is defined as consisting of non-executive directors who comply with a strict definition of independence. This "independence test" requires the director should have absolutely no connection to the company other than the office of directorship. The definition excludes the non-executive director who holds office as a "representative of a shareholder who has the ability to control or significantly influence management" (2002, 25, i). In addition to this the definition requires that the independent should "not (have) been employed by the company or the group of which it currently forms part, in any executive capacity for the preceding three financial years" (2002, 25, ii).

The concept of independent director is not unique to *King II* as it is also found in the *Cadbury Report* (1992). It is worth noting, however, that the definition adopted by *Cadbury* is not as stringent and clearly set out as that in *King II*, in fact, the UK report stipulates that "it is for the board to decide in particular cases whether this definition is met." (22, 4.12).

Granting such a wide discretion to the board may defeat the purpose of requiring that independent directors should be elected to the board.

The *Cadbury Report* (1992) does however provide for additional protection in ensuring that non-executives have a "strong voice". In terms of the *Cadbury* proposals this comes in the form of the <u>senior</u> non-executive director. The senior non-executive is to play a significant role in the performance appraisals of the board and chairman. *King II*, however, does not introduce the British concept of the senior non-executive director.

The requirement of independence of non-executive directors has in recent years received greater emphasis internationally with the test of independence becoming stricter and stricter. *Hermes Investment Management* for example have developed the following test of independence:

> "..to be independent a NED must not:
> - Be or have been an employee of the company
> - Serve as a director for more than 10 years or be over 70 years of age
> - Represent significant shareholders or other single interest groups (eg supplier, creditor)
> - Receive an income from the company other than NED fees
> - Participate in the company's share option or performance-related remuneration schemes
> - Have conflicting or cross directorships
> - Have any other significant financial of personal tie to the company or its management which could interfere with the director's loyalty to shareholders" (2001, 2.3.).

2.4.2. Separation of the Roles of Chairman and Chief Executive

King II has called for a clear separation of responsibilities at the head of the company to ensure that "no one individual has unfettered powers of decision making" (2002, 24, 2.3.1). The committee has gone on to recommend that the chairman should be an independent non-executive director. (Ibid, 2.3.2). In addition to this it is recommended that different individuals should hold the roles of chairperson and chief executive officer. What is interesting to note, however, is that *King II*, acknowledges that the roles may, in exceptional circumstances, reside in one director. Where this is the case, *King II*, recommends that there should either be an independent non-executive director serving as deputy chairman or a high proportion of independent non-executive director in the board composition. The responsibility is placed on the company to justify the combination of the roles each year in its annual report (Ibid, 24, 2.3.4).

In South African board structures it is very common to find that the non–executive director, and often the chairman, is a retired executive of the company. One would be justified in questioning the independence of such directors when they have served, often for numerous years, as executives in the company. Of the various codes that have been studied, that of *Hermes* is strictest in this regard. The *Hermes* code specifically disqualifies a director who has, at any time, acted in an executive capacity for the company from becoming the non–executive chairman. As mentioned above *King II* would regard an executive as qualifying as a non-executive in the 'independence test' after a period of three years of no association with the company.

2.4.3. Audit Committees

In the *Code of Corporate Practice and Conduct* of *King II* it is recommended that "at a minimum, each board should have an audit and a remuneration committee" (2002, 29, 2.7.5). *King II* provides further recommendations with regard to this sub-committee of the main board. It is stipulated that the chairman of the audit committee should be an independent non-executive director and not the chairman of the main board. It is also recommended that the membership of the audit committee should be disclosed in the annual report of the company.

The *King I* had identified the following five main areas of responsibility for these committees:

- Review of the internal control structure of the company including financial control, accounting and reporting systems,

- Review the internal audit function,
- Liaison with external auditors
- Monitoring the compliance of the company with legal requirements
- Monitoring compliance to the company's code of conduct.

The roles and functions of the audit committee in ensuring good governance is expanded in *King II* by a section in the report on "Accounting and Auditing" and a section on the "Internal Audit Department" of the company. *King I* has also paid attention to the role of the audit committee in ensuring that the external auditors are independent of the company. The view expressed by *King II* is that the provision of the non-audit functions by the accounting firm, which is the external auditor, should not necessarily disqualify the firm from fulfilling the audit function (134, 8). It is the responsibility of the audit committee to evaluate the independence of the firm on a "case-by-case basis, thereby preserving a company's ability to select its external auditor for non-audit services, if, in the circumstances, that is the best choice for the company and the investors" (134, 9). (This same issue has received much attention in the United States in the failure of Enron and the role of the Anderson group in the provision of both audit and consulting services).

The approached adopted by *King II* is to clearly define the responsibility of ensuring selection of an independent auditing firm in the hands of the audit committee. This task would involve establishing the overall functions and services provided by the firm, which has been selected, and knowledge of the services which of these services have been obtained from the firm by the company or its subsidiaries.

2.4.4. Remuneration Committees

The second King Committee's *Code of Corporate Practices and Conduct* (2002) has raised the stakes in this controversial area by recommending that the remuneration committee should "consist entirely or mainly of independent non-executive directors" (2002, 26). In addition to this it is recommended that this committee should be chaired by an independent non-executive director (*Ibid*). *King II* has also recommended that "companies should disclose the earnings, share options, restraint payments and all other benefits of each individual director" (2002, 57, 11).

This aspect of corporate governance is probably the most controversial aspect. It is one, which receives a huge amount of publicity. The establishment of a remuneration committee is thought by corporate governance proponents to result in two levels of governance. Firstly to more closely align the remuneration of the directors with the interests of the shareholder, usually by the introduction of incentivised pay, and secondly, to serve as a check on the level of pay awarded to directors. The second point is based on the view that the directors should not placed in a position where they have a conflict of interests in that they establish their own salaries while at the same time represent the interests of the company. The above reasons for establishing remuneration committees are more closely associated to the Agency and Abuse of Executive Power Models of corporate governance. It may also be argued that linking executive remuneration more closely to overall corporate performance is in the interests of all stakeholders, including employees, society and shareholders.

The on-going pursuit of establishing a closer link between corporate performance and executive remuneration has been the topic of much research in both academic institutions and in business generally. In research first published in 1993, Main & Johnston examined the role of remuneration committees in large publicly held UK companies. The researchers found that 30% of their sample reported having a remuneration committee. In addition to this it was found the existence of a remuneration committee had no positive impact on incentive pay structures. In the regression analysis which was conducted Main and Johnston also sought to determine whether the existence of a publicly declared remuneration committee had any influence on the level of CEO pay. The authors found that there was a <u>statistically significant increase</u> in the levels of CEO pay associated with the introduction of remuneration committees. Of further concern, to proponents in favour of this corporate governance structure, was the finding that the significance of the above relationship only decreased slightly with the introduction of the variable of, 'ratio of non-executive directors to total directors' on the committee. This ratio also had no influence on the structure of executive remuneration and the level of incentivistation. This would seem to imply that non-executive directors failed to keep executive remuneration in check.

Probably the most surprising finding of the above research was that the presence of the CEO on the remuneration committee had no statistically significant bearing on the level of CEO pay. It was, however, established that the presence of the CEO on the remuneration committee had a significant impact where the CEO was also the chairman of the board and the highest paid director.

On the brighter side, Main and Johnston (1993) conclude that their research findings do not represent the basis of a case against remuneration committees. Instead they are of the view that their findings point to the significance of the selection and composition of the committee and board. The authors suggest that the role of the nomination committee in the selection of non-executive directors (and preferably independent non-executives) is an essential component in establishing an effective remuneration committee.

Conyon (1995) has suggested that the research conducted by Main and Johnston does not point to remuneration committees contributing to pay increases. Conyon suggests that there are two reasons why this conclusion cannot be supported by the research of Main and Johnston. Firstly the data relied on by Main and Johnston was cross sectional in nature, meaning that it was confined to a particular year. It cannot thus account for firm specific effects. Secondly, a problem of reverse causation may be present in that the companies which are more innovative are likely to be high performing and thus more likely to pay their directors more and also more likely to adopt the practise of remuneration committees.

Ezzamel and Watson (1997a) conducted research amongst a sample of 199 companies from *The Times Top 1000* list in the UK. The study was conducted shortly after the Cadbury Committee published its recommendations that public companies should establish remuneration committees made up of non –executive directors tasked to ensure that the remuneration of executives is linked to both corporate performance and increases in shareholder value.

The purpose of the study was mainly to establish whether executive remuneration was more closely linked to corporate performance and the creation of shareholder wealth or whether external market forces were better predictors of remuneration levels. Ezzamel &

Watson have established that executive pay level are mainly influenced by company size (proportion of non–executive directors is highly correlated with company size), and that external executive remuneration market comparisons are far more significant in explaining levels of remuneration than company performance. (p. 85). In addition to this the existence of institutional shareholders and separation of the roles of chairman and chief executive also had no impact on the growth rate of executive remuneration over the sample period (Ezzamel & Watson, 1997a).

This seems to support earlier research conducted by Conyon (1995), in which it was found that although ownership concentration and control limited the level of executive remuneration, these variables have no influence on the increase rate of remuneration.

Ezzamel and his colleague also raised the question as to whether "strong social influence considerations" (Ezzamel & Watson 1997a p.71) play a role in setting the level of remuneration granted by such committees. The argument is, basically, that non-executives sitting on remuneration committees are extremely likely to use their level of remuneration in their own companies as a gauge of reasonableness.

The authors found that the external executive remuneration market comparisons also play a significant role in the remuneration growth rate of executives in that executives, that were found to be "underpaid" in the previous financial year, were more likely to receive larger increases in the subsequent year. This is referred to as the "bidding –up hypothesis in that remuneration committees are thought to bid up the level of remuneration placing greater significance on retaining human resources as opposed to keeping executive remuneration in check (Ezzamel & Watson, 1997a, p. 85).

The social influence consideration thus appears to be a major force in the determination of executive remuneration. This issue may be stronger in boards which lack the necessary diversity to bring challenging debate to the issues of both director appointments and director remuneration.

Finally it was found that the characteristics of the remuneration committee and corporate governance variables such as, separation of chairman and CEO and board composition did not, overall, result in a stronger relationship between executive remuneration and company performance.

This research was conducted mainly with the interests of shareholders in mind –hence the frequent reference to corporate performance. It would be interesting to approach the issues from a broader stakeholder basis. Doing so may require that one not only evaluate the director in terms of the creation of shareholder value but also in terms of, for example, his contribution to the development of employees, retention of skilled staff and the contribution which the company has made to society. The latter issue is particularly relevant in a developing country such as South Africa with its unique disparities amongst its people.

There is currently an actual practical example of a company, in the financial services industry, which has of linked executive remuneration to socio –political needs. The company concerned will penalize its management in terms of a deduction from their annual bonus payments for not attaining Employment Equity Act quotes amongst it employees.

2.4.5. Nomination Committees

King II has recommended that companies establish nomination committees comprising only non-executive directors. It also recommended that the chairmanship of the committee should be with the chairman of the main board. This is a departure from *King I* which felt that the nomination of directors should be the responsibility of the board as a whole. *King I* was thus not in favour of establishing nomination committees.

Turning to the academic research on the issue of director selection one finds that there is a great deal of empirical evidence which supports the contention that the control over the selection and appointment of employees is a cheap, easy and efficient means used by managers to build political coalitions. This has prompted numerous corporate governance experts to conclude that CEO control over the director selection process constitutes a form of management entrenchment. (Examples quoted by the authors Zajac & Westphal (1996) include, Frederickson *et al*, 1988, Lorsch & McIver 1989, and Wade *et al*, 1990).

These issues were investigated further when Zajac & Westphal (1996) conducted research on board appointments amongst *Forbes* and *Fortune 500* companies in order to establish whether any differences existed between the board appointments conducted by powerful CEOs and those conducted by powerful boards. It was hypothesized by the authors that the powerful CEO would seek to preserve his power and control by; firstly, avoiding the appointment of director candidates who have participated in greater board control over management and secondly, rather appointing directors whose experience on other boards exhibited board passivity to management. Similarly, the authors hypothesized that powerful boards were able to increase their control over management by avoiding passive director appointments and, instead, appointing individuals with experience of boards asserting control over management.

Zajac & Westphal(1996) utilised the following indicators of director's 'greater board control experience', namely:
A prior board experience of increasing the ratio of non-executive to executive directors,
The separation of the positions of CEO and Chairman,
The decrease of corporate diversification,
The decrease of executive compensation
The decrease of CEO variable pay

As indicators of experience of board passivity the researchers relied on director experience of the converse of the above experiences. For example, decreasing the ratio of non-executive to executive directors, directors with board experience where the roles of CEO and Chairman have recently been combined, etc.

The researchers found that directors who had prior experience on more passive boards were significantly more likely to have subsequent appointments to passive boards or "strong CEO" boards. These results were robust over all the indicators of increasing and decreasing board control.

Finally the authors found that the positive relationship, identified by Farma (1980), between the increasing attractiveness of the director in the market and the financial performance of the firm was only true for the subset of boards with high control over management. This, the authors have concluded, seems to suggest that the reputational effects of directors are more complex than previously thought (Zajac & Westphal 1999, 41).

As has been pointed out in the section on the establishment of remuneration committees and the creation of a "balanced board", the role to be played by the nomination committee is essential in ensuring good corporate governance. A study conducted by Conyon (1995) in the United Kingdom found that only half of a sample of 298 companies had, at that time, adopted nomination committees. The adoption of nomination committees appears to be far more widespread in the United States with Monks and Minow (1995) reporting that 95% of large US corporates rely on a nomination committee to make recommendations for boardroom appointments.

2.4.6. Role of Institutional Shareholders

King II expresses the view that institutional investors should play a more active and transparent role in enforcing good corporate governance in the companies in which they have invested. The committee is also of the view that the lack of shareholder activism in South Africa "seriously undermines good levels of managerial compliance" (2002, 151, 7). *King II* also refers, with what seems to be approval, to a practice, which is developing internationally in terms of which institutional shareholders who do not attend shareowners' meetings of companies in which they have a certain minimum shareholding are censured.

The roles which institutional shareholders play in the companies in which they have invested has received much academic interest, the research of which seems to indicate that the issue is relatively complex, and that it may not be wise to force institutional shareholders to play a more active role in the companies in which they have invested.

Pound (1988) presents three hypotheses, which, are based on the relationships between the institutional investors and their incentives to intervene in corporate governance issues. According to Pound it is the relationship between the institutional investor and the company which is most likely to influence the nature and extent of intervention. He has according proposed three hypotheses to explain this role.

In terms of his Efficient Monitoring Hypothesis, institutional shareholders are more informed and thus able to monitor management at lower costs than are small shareholders. This hypothesis would suggest that there is a cost and efficiency advantages to institutional investors enforcing corporate governance.

The above hypothesis as submitted needs to be reviewed since its inception. It may be argued that in the 21st century - information age the discrepancy between institutional shareholders and small private shareholders has diminished.

The Strategic Alignment Hypothesis holds that institutional investors and the board may find it mutually advantageous to co-operate on certain issues. In sharp contrast, the Conflict of Interest Hypothesis suggests that the institutional shareholders may, due to current or future business dealings with the firm, be less willing to actively intervene and limit management discretion.

The role that institutional shareholders are able to play in ensuring good governance was recognized in the United Kingdom by the *Cadbury Report* (1992) where it was noted that, "Because of their collective stake, we look to institutions in particular, with the backing of the Institutional Shareholder's Committee, to use their influence as owners to ensure that the companies in which they invested comply with the Code" (para. 6.16). The *Cadbury Report* suggested that the market solution represented by more officious institutional investors was actually preferred to regulation as a solution to poor corporate governance.

This view is supported by *Hermes Investment Management Ltd*, who in their *Statement on UK Corporate Governance & Voting Policy 2001* (2001) state that it is their belief that "companies with concerned and involved shareholders are more likely to achieve superior long-term returns than those without. Good stewardship creates value" (Hermes 2001, p.1).

It is not surprising that an Investment Manager, which has as its focus the investment of pension fund money, has adopted this position. It is also worth noting that there are contrary views to that which has been publicly adopted by *Hermes*.

As mentioned the second King Committee report is also supportive of institutional shareholders playing a more active role in corporate governance. In fact an entire chapter in the *Compliance and Enforcement* section of the report is devoted to "Encouraging Shareholder Activism". The committee goes as far as to suggest that "sanctions should be visited upon directors and the management of companies, notably institutional shareowners, who fail to attend shareowners' meeting of the companies in which they are invested" (King, 2002, 150).

Both *Cadbury* and *King II* seem to adopt the Efficient Monitoring Hypothesis as their main support for the call for greater shareholder activism. What is not entirely clear to the author is the extent to which greater shareholder activism is in keeping with the Stakeholder Model or "inclusive approach" referred to in *King II*. It may be that more assertive shareholders, especially large financial institutions, may result in companies which are more aligned to the interests of shareholders and less concerned about the needs of other, equally important, stakeholders.

The research literature is divided on the likely success of placing higher governance responsibilities on institutional shareholders and it is clear that the above recommendations are largely at odds with the historical and current way in which many institutional shareholders view themselves.

Hirschman (1970) for example, argues that institutional shareholders view themselves not as shareholders who will hold the directors of the company accountable but rather as holders of commodities, which they are easily able to sell –off should there be any sign of concern over the value of their investment. Charkham (1990), points out that for institutional shareholders to adopt a proactive monitoring role they need to view themselves as co –owners of the companies in which they are investing and not merely as holders of short term easily tradable commodities. Furthering this theme Charkham (1994) refers to the, now widely articulated view, that the Anglo-American style capital market with its emphasis on liquidity and the division of institutional shareholders form the firms they invest results in poor managerial supervision and neglect of the shareholder value maximization approach. More recently, Short and Keasey (1997), correctly it is submitted, state that due consideration should be given to the objectives of institutional shareholders and their willingness and ability to govern corporations before one attempts to place additional responsibilities on these institutions.

Taking the matter further, Short and Keasey (1997) suggest three reasons why institutional shareholder may be more willing to exit problem companies rather than to attend to improving governance. Firstly, if the institutional investor intervenes publicly they may draw further public attention to the difficulties of the company. This may be perceived by the market as bad news and may further reduce the investment holdings of the institutional investor. Secondly, if they become involved in the management of such problem companies they may become party to "insider information" which may impact on their ability to trade in the shares of the company thus compounding potential losses. Finally, the authors suggest that the costs associated with corporate governance monitoring a diverse portfolio of shares are costly and may outweigh the benefits gained (Keasey, p.28). This last argument is particularly powerful in the case of a short investment-holding period.

It is thus suggested by the authors that the fund managers, and ultimate beneficiaries of institutional funds may not be ideal monitors of corporate governance. The reasons for this are that the institutional investment managers are motivated to achieve short-term performance, which may often be at the expense of long-term corporate governance considerations (Ibid p.23) In addition to this, one needs to consider well documented economic phenomenon of the "free –rider". Corporate governance inevitability would involve the individual institutional investor incurring costs. To the extent that other institutional investors may also assume the role of monitoring governance, and the benefits of such governance are share by all there may be a tendency for all institutional investors to adopt a 'wait and see attitude', each waiting for the other to incur the costs of added governance.

According to the capital market theory of corporate governance, institutional shareholders have a significant governance role to play in their ability to lead corporate takeovers of under performing companies and in this way "firing" poor quality senior management. This market for corporate control is seen by Jensen (1986) and Hart (1995) as the governance mechanism of last resort, which is adopted when the internal mechanisms have failed.

The market for corporate control, and by implication the role of the institutional shareholder, is not universally accepted as the most efficient form of corporate governance. O'Sullivan (1997) referring to research studies spanning over four decades, by numerous academics, has identified five criticisms of the corporate control model. Firstly, the free rider problem referred to above exists in that the benefits of launching a takeover bid weighed up against the costs may mean that shareholders are reluctant launch such "disciplinary action". Secondly, an active market for corporate control may lead to managers being too focused on short-term performance and neglecting long-term investment opportunities. Thirdly, after takeovers implicit long term contracts, especially contracts promoting investment in firm specific assets, adopted by the original management are reneged upon as the new owners do not feel obliged to uphold such. Fourthly, the takeover process may be manipulated by managers of the bidding firm for their own agendas, for example entrenching themselves as indispensable, and even commanding higher salaries. Finally, the large transaction costs associated with takeovers mean that this mechanism remains a financially inefficient governance mechanism of last resort.

O'Sullivan (1997) has also suggested that the numerous defensive strategies adopted by management of the takeover target in order to often make the takeover financially unviable also limit the efficiency of this as a governance mechanism.

According to O'Sullivan (1997) the research conducted in order to determine whether takeover activity is a successful governance mechanism has focused on two measures. Firstly an examination of the benefits to shareholder, in terms of share price movement after the takeover and secondly, a comparison of accounting data before and after the takeover. The author concludes that the research is inconclusive. Evidence does seem to indicate that there is often change in management after a takeover but this in itself is not indicative of poor management being replaced as the research has not been able to establish the motives for management turnover.

According to Jensen and Warner (1988) institutional shareholders are playing a greater role than has been the case in the past in influencing the managers of under performing firms, in which they have invested, to refocus the strategies which they have adopted. According to Maug (1998) institutional shareholders in the United Kingdom and United States are using their considerable influence to force companies to adopt shareholder value maximizing strategies.

This research appears to contradict the studies conducted by Charkham (1994) and seems to imply that "the voice option is becoming more popular than the exit option".

On the other hand as was discussed in section 1.2 above, this increased "institutional shareholder activism" may not necessarily mean that a stakeholder model of corporate governance is not being followed. These shareholders may recognize, as Hill and Jones (1992) have, that long-term shareholder value may be achieved in protecting and balancing the interests of all stakeholders.

Adopting an Agency Model definition of corporate governance, Dockery *et al* (2000) investigated the impact which institutional shareholders had on the strategies adopted by managers of large European companies. It was found that the institutional shareholders play a more active role in the management of the companies in which they have invested than do companies in the United Kingdom. This has lead to management of European companies adopting a longer-term view in their adoption of shareholder wealth maximizing strategies.

Dockery *et al* conclude that there appears to be a reorientation of boards of directors to shareholder interests (Ibid p. 25).

If this is indeed the trend in the United Kingdom and United States it is contrary to that adopted by *King II*. Although the Stakeholder Model adopted by *King II* may be suitable for the socio-political environment in South Africa, one may surmise that, according to the findings of Dockery, it does not auger well for South Africa's ability to attract foreign investment as foreign institutions will expect the shareholder's interests to be paramount to those of other stakeholders.

The obvious counter to the research findings of Dockery is that corporations globally are beginning to recognize the financial benefits of corporate social responsibility, although the benefits may be of a longer-term nature. On the other hand it is also entirely likely that these foreign investors may be less concerned with such considerations as they see themselves as the holders of short-term tradable securities and not co-owners of the company. This has increasing been the experience of emerging markets around the world have of large institutional 'first world investors'.

Chapter 3
Case Study Description and Results

3.1. Introduction

This section consists of a presentation of the research, which was conducted into the corporate governance structures of six companies listed on the financial services sector of the Johannesburg Stock Exchange. Initially it was believed that the research would be conducted by drawing information from the annual reports of the sample companies. The author, however, quickly established that this method of data collection would not be successful because:

- It was difficult and time consuming to obtain financial statements for past financial years
- The financial statements often failed to contain the data needed for the research
- The disclosure of the data was not consistent in terms of the detail required over all the years of the study period
- The actual public disclosure of the data was not the main area of research because the researcher was more interested in the existence of governance structures *per se.*

Consequently, the companies were approached by e-mail questionnaire in order to provide details of their corporate governance structures.

3.2. Sampling Strategy

A convenience based sampling strategy was utilised, as there was no need for a scientifically based generalization of the research findings to the population parameter. In addition to this, the cost and time requirements associated with a random sampling technique were prohibitive. This inevitably led to the use of the simpler sampling strategy. The researcher also felt that it may be more difficult to elicit responses from "penny stock companies" and that the larger more well known public companies may be more receptive to research into their corporate governance characteristics.

The sample frame thus consisted of those companies listed on the financial services sector of the JSE as at December 2001. This produced a list of forty companies. For the companies to remain in the sample it was required that they had been listed at least since 1997. It was felt that this limitation would provide companies which are more likely to have suitably complex governance structures in place which may have evolved through practical experience. In order to further limit the sample size it was decided to select only those companies whose share price exceeded 500c. This produced a sample of six companies varying in size from 120 employees to 5 500 employees. The market capitalisation of these companies ranged from R138 million to R 5 175 million (as at December 20001). It was felt that the selection methodology had not introduced a size bias to the sample and that, although not a probability based sample, it was felt that the sample was a relatively fair reflection of the financial services sector of the JSE. (As opposed to the Banks sector).

The final sample consisted of the following six companies:

- Alexander Forbes Ltd
- African Merchant Bank Holdings Ltd
- Brait South Africa Ltd
- Coronation Holdings Ltd
- PSG Holdings Ltd
- Sasfin Holdings Ltd

These companies were contacted between February 2002 and April 2002. In the first instance, February 2002, the corporate secretarial departments of the companies were contacted by means of e –mail and were given two weeks in order to reply. This resulted in one response. A follow up e-mail was sent out in March 2002, which resulted in a further three responses. At the end of March 2002 telephonic contact was made with the non-respondents in order to establish the correct contact person and the willingness to participate in the research. The reasons for this were as follows:

- There was no certainty that the e-mails had reached the correct people. (It was discovered for instance that one of the respondents had been transferred to a subsidiary and was no longer employed in the corporate secretarial department. He had delegated the task of reply to a colleague).

- In one case the e-mail reply had gone astray,
- Given the size of the sample and the fact that sample methodology was non-random in nature it was felt that the additional and alternative means of contact would not add any bias to the quality of the data.

The final e-mail questionnaire was sent out in the first week of April and all remaining responses were received and collated by the end of the second week of April 2002.

(The researcher was aware of the fact that the Second King Committee report was published on the 26 March and that this may have influenced the likelihood and detail of the response of the remaining respondents. It was, however, felt that due to the objective nature of the questionnaire, the closed questioning technique adopted and the sampling methodology which had been adopted this influence would not have a material effect on data quality).

The decision has been made not to disclose the identity of the above companies in the following tabulations. The reason for this is that the author failed to expressly raise this issue with the companies concerned. In addition not all the information that was gathered was available in public records such as the companies' annual reports.

3.3. Case Study Findings

The responses of the six companies are examined in relation to each of the specific governance structures. The overall findings indicate that the companies have very similar governance structures and mechanisms in place.

3.3.1. Composition of the Board

In order to obtain the information required to evaluate the composition of the board each company in the sample was asked to provide information on the number of executives and non-executives on the main board in each of the years from 1999 to 2001. The companies were also asked to reflect whether the chairman of the board was an executive or non-executive director of the company. Table 3.1 reflects the average numbers of directors on the boards of each of the companies. These results indicate that, on average non-executives where in the majority on the boards over the period of the study. The average number of directors has remained relatively stable over the three-year period. The table also indicates that, on average, the companies exceed the minimum requirement of three non-executive directors as set by *Cadbury* (1992).

Ave. Board Composition Summary			
Year	**1999**	**2000**	**2001**
Executives	4	3	4
Non –Executives	7	7	6
Ave. Board Size	12	10	10
Chair Exec.	1	1	0
Chair Non-exec.	5	5	6

Table 3.1

Proportion of Non-executive to Total Board							
Company	**A**	**B**	**C**	**D**	**E**	**F**	**Ave.**
Board Prop. 1999	0.47	0.71	0.55	0.63	0.75	0.71	0.64
Board Prop. 2000	0.75	0.64	0.58	0.50	0.79	0.71	0.66
Board Prop. 2001	0.56	0.54	0.58	0.43	0.80	0.71	0.60

Table 3.2

Table 3.2 indicates, for each of the companies over the study period, the extent to which the non-executives in a given year where in the majority. Where the factor reflected in the table is less that 0.50, it means that non –executives where in the minority. Conversely factors greater than 0.50 indicate that the non-executives were in the majority. Apart from company F, the board composition of companies varied thorough out the study period. Companies A and D are the only companies which had a year in which the non-executives were in the minority. It is surprising that company D as late as in 2001 had non-executives in the minority. Company C consistently had a ratio of non-executive to overall board composition below the average composition of the sample. Company E's board composition in 2001 was 80% non-executive.

These statistics do not reflect whether any of the non-executives were independent as defined in *King II*. The general trend gleaned from information obtained from some of the companies indicates that few independent directors are ever appointed. The requirement of independent directors is going to present a serious challenge to many companies. Company E for example appears to have a large proportion of non-executive directors. In reality though only 2 to 3 of these may qualify on the *King II* 'independence test' as the majority of the company's non-executives were executives in subsidiary companies of company E.

3.3.2. Separation of Roles of CEO and Chairman

The companies were asked to indicate whether the same person in each of the years in question had held the positions of CEO and Chairman. Table 3.3 indicates whether these positions were held by two individuals (denoted in the "separate" column) or one individual (the "Joint Position" column).

Chairman and CEO			
Year	1999	2000	2001
Companies with Separate	5	5	5
Companies with Joint Position	1	1	1
Total Sample	6	6	6

Table 3.3

As may be seen from this table the vast majority of companies had a clear separation of the role of CEO and Chairman. Only one, and the same, company over the research period reported that one individual occupied both positions. It is further interesting to note that the company that combined the roles of CEO and Chairman was company E, which, in table 3.2 had the highest proportion on non-executives to the overall board. The practice of combining the roles of CEO and Chairman is discouraged in both *King I* and *King II*. Company E would have needed to provide reasons for he combination of the roles in its annual financial reports for each of the years in question.

3.3.3. Audit Committees

The companies were surveyed to establish whether they had an "audit committee represented by board members and, if so, to then indicate the composition of the committee". The companies were also asked to indicate whether the chairman of the committee was an executive or non-executive.

Audit Comm. Proportion of Non-executive to Total Membership							
Company	**A**	**B**	**C**	**D**	**E**	**F**	**Ave.**
Board Prop. 1999	0.67	0.80	0.67	0.67	0.75	1.00	0.76
Board Prop. 2000	0.67	0.80	0.67	0.50	0.33	1.00	0.66
Board Prop. 2001	0.67	0.75	0.67	0.50	0.33	1.00	0.65

Table 3.4

Audit Committee Chairman			
Year	1999	2000	2001
Executive	0	0	0
Non –Executive	5	5	5
Other	1	1	1
Total	6	6	6

Table 3.5.

As may be seen from table 3.4 the almost all of companies had audit committees comprised of a majority of non-executives. Company F had no executives present on its audit committee. Company E is the only company that had a majority of executives present on its audit committee during the years 2000 and 2001. Company E also reported that the chairman of its audit committee was not a board member, this is indicated by the **"other" row in table 3.5. The position was, presumably held by a representative of the** company's external auditor. This would have added an element of independence to the committee to, hopefully, balance the effect of the majority of executives on the committee.

3.3.4. Remuneration Committee

In determining the characteristics of the companies' remuneration committees, the same questions posed in respect of the audit committee structure was phrased to apply to remuneration committees.

Given that this area of corporate governance is extremely controversial it was anticipated that all six companies in the sample would have remuneration committees fully compliant to *King I* and possibly even *King II.*

Table 3.6 indicates that only company D had a remuneration committee comprised solely of non-executives. If these non-executives were found to be independent of the company this composition would be fully compliant to *King II* and *Cadbury*. Company D's main board consisted of five non-executives in 1999, and three in 2000 and 2001. All these non-executives also sit on the remuneration committee and it is highly unlikely that they are all independent.

None of the companies had a majority of executives in their remuneration committees. . There appears to be no clear trend in the composition of remuneration committees over the three-year period. Companies D, F and C kept their committees unchanged while companies A and B reduced the proportion of non-executives on their committees. Company E, which in 1999 sported an executive as chairman of its committee actually increased the number of non-executives.

Remuneration Comm. Proportion of Non-executive to Total Membership							
Company	**A**	**B**	**C**	**D**	**E**	**F**	**Ave.**
Board Prop. 1999	0.80	0.75	0.67	1.00	0.75	0.67	0.77
Board Prop. 2000	0.60	0.60	0.67	1.00	0.67	0.67	0.70
Board Prop. 2001	0.60	0.60	0.67	1.00	0.80	0.67	0.72

Table 3.6

Remuneration Committee Chair			
Year	1999	2000	2001
Executive	1	0	0
Non –Executive	5	5	5
Other	0	1	1

Table 3.7

Table 3.7 illustrates whether each of the six companies in the sample had an executive director or non-executive director chair their remuneration committee. As can be seen the majority of companies in the sample had non-executive chairmen. Company E is the only company that had an executive director chair the remuneration committee, this practice changed during the years 2000 and 2001 when a non-board member was appointed as the chairman of the remuneration committee. (The non-board member chairman is denoted in the "Other" row of table 3.3.4b).

King II requires that remuneration committees should consist entirely or mainly of independent non-executives. This is going to require all of the companies in the sample to change the composition of their respective committees.

3.3.5. Nomination Committees

This question was posed to establish whether, inspite of there being no requirement for companies to form nomination committees, companies had taken a proactive stance and established such committees in line with recommendations in the United Kingdom. It was established that none of the companies had established nomination committees. Two of the respondents however indicated being aware of such a recommendation in the *King II* report and indicated an intention to establish such a committee with a membership structure identical to the company's existing remuneration committee during the course of 2002. These two companies were company A and company F.

3.3.6. Institutional Shareholder Representation

Of the six companies only company A indicated that institutional shareholders had been represented on its board during the period concerned. This situation changed over the period. Initially the shareholder representation fell away due to the group of subsidiary companies unbundling. During the 1999 year however, the company again took on institutional shareholder representatives, who were referred to by the company as "Black Economic Empowerment non-executive directors".

The results obtained from the sample of companies were not of any use in analyzing the effect that institutions may have on the corporate governance structures of the sample. The research referred to in section 2.4.5 also indicates that institutional shareholders need not be represented at board level in order to influence the corporate governance in the companies in which they have invested.

3.4 Summary

Overall it was found that all of the companies make extensive use of non-executive directors. The number of directors has remained relatively stable over the three-year study period. Generally non-executive directors are in the majority on the companies' main boards and on the boards of sub-committees. It was not possible to establish whether the non-executives were "independent directors" as defined in *King II*. Such independence is, in the author's view, a crucial requirement in ensuring that the needs of all stakeholders are balanced.

Chapter 4
Research Findings and Discussion

4.1. Introduction

This chapter is, with the support of existing research literature, a further evaluation of the governance structures referred to *King II* and the actual structures identified in the sample of companies discussed in chapter three. The intention is not to pay equal attention to each of the governance structures investigated in the sample of companies but rather to create meaning in how the structures relate to one another. There is a need to critically address whether the actual introduction of governance structure in themselves are of any benefit in promoting good governance.

4.2. Board Structure and the CEO

Fama & Jensen (1983a,b) conducted research into board structure and the impact of the separation of the ownership and control. These authors were of the view that the where there is a separation between the ownership and control, the costs associated with the composition and control characteristics of the board (informational costs and organizational costs) may only be minimized if there is a distinction drawn between the actual initiation and implementation of decisions on the one hand, and the ratification and monitoring of these decisions on the other hand. They suggest that the minimization of agency costs can only occur if the responsibility for the ratification and monitoring of decisions lies with the shareholders. This is because only the residual risk bearers should be responsible for the evaluation of decisions because any costs associated with the adopting inefficient strategies will be borne by the shareholders. The Fama and Jensen model requires the board to be the representatives of the shareholders and independent of the executives who would be responsible for the initiation and implementation of decisions. The problem of combining the monitoring role of independent non-executives and the decision implementation role of executives in one board is that the information available to these two role players is asymmetrical. The non-executives are reliant on executives for the provision of information and as such are at a disadvantage in the fulfillment of their role as monitors. Jensen (1989) recognizes this problem in later work and actually questions whether independent non –executive directors who have no equity stake in the corporation are, in practice, really able to control and discipline the very executive directors who have nominated them to office and then supply them with the information required for them to conduct their jobs. This criticism points to the need for an effective nomination committee, an issue that has been identified by *King II* (2002), but which in has not received sufficient emphasis. This is because in the "Code of Corporate Practices and Conduct" the committee stipulated that "at a minimum, each board should have an audit and a remuneration committee" (*King*, 2002, p.29). The King Committee should have recognized that the need for an effective nomination committee is as essential as the need for an Audit or remuneration committee.

The criticism one may level at the Farma and Jensen model is that it assumes that the sole residual claimants are the shareholders. The model fails to recognize the existence of employees, customers and society as equal stakeholders. (In other words the model suffers the flaws of an Agency Model, as defined by Blair (1995). This is well recognized in South Africa by *King II* and the modern regulatory environment. (For example South Africa's progressive labour legislation). Farma and Jensen also fail to acknowledge that the fact the owner –manager firms often have identical "stakeholder protecting" regulations to comply to as firms where the roles of ownership and management are separate.

The ideal composition of the board is a complex issue and research seems to indicate that a majority of independent non –executive directors will not necessarily result in the ideal structure. Support for this is found in a study conducted by Byrd and Hickman (1992) in the USA. In their study Byrd and Hickman investigated the impact of independent non-executive directors on the tender offer bids, it was established that although shareholders appeared to benefit from the presence of independent non-executive directors, there is a diminishing benefit to shareholders when the proportion of non-executive directors approaches 60%.

In the sample of companies investigated in this research (see table 3.2.) companies E and F consistently had a proportion of non-executive in excess of 60% of the board. The sample average non-executive board proportion was also above 60%.

It is worth noting the current research did not identify the whether the non-executive directors where independent (as defined in *King II*) as it was felt that the complexity of the definition would have caused confusion in the administration of the questionnaire. The researcher has never-the –less established that very few of the non-executives in the sample would actually qualify in terms of the *King II* independence test. It is common knowledge that South African companies often appoint retired executives to non-executive board positions this, to the uninformed investor, creates the impression of balanced board, when in fact one would find such non-executive not acting in a totally independent manner.

Although the establishment of the category of independent non-executive directors (as has been recommended by *King II*) may help to promote good corporate governance, the manner in which these directors are be selected will ultimately play a very important role in ensuring their independence and strength of character. In other words the success of adding these independents is dependant largely on whether the nomination process, which may or may not take place through a nomination committee, is functioning correctly.

Research conducted by Kini *et al* (1995) into "disciplinary takeovers" of under performing firms established that the effect such takeovers had on shareholder wealth seemed to be related to the characteristics of the board of the under performing firm in that the under performing firms appeared to have an unbalanced board with either too many independent non-executives or too may executives. The unbalanced mix was addressed soon after each takeover.

It would thus seem that it is possible to have too many independent non-executives.

Hermes (2001) has, in its code, devoted an entire section to the role of the senior non-executive directors. It stated that it supports the combining of the roles of independent deputy chairman and senior non-executive director. The senior non-executive director's main job is to chair as many of the board sub-committees as possible. According to *Hermes* the senior independent non-executive director should also have the authority to call a meeting of the non-executive directors. *King II* (2002, 57, 9) has also approved the practice of appointing a senior non-executive director by suggesting that South African boards should consider this in circumstances where there is conflict between the board members or the chairman needs assistance in fulfilling his tasks.

Although the need for a senior non-executive may be necessary in certain circumstances, for example where the CEO is an extremely forceful individual and the non-executive directors are relatively inexperience, it may not be beneficial to have such an appointment in all cases. It may not be wise to appoint a senior non-executive if this is merely going to lead to an unbalanced board, by 'substituting' one "controlling" individual viz. the CEO with a senior non-executive.

Research conducted into board composition and the possible impact, which this may have on corporate performance, has helped to categorize earlier research paradigms. Zajac & Westphal (1996), for instance, have identified three streams of research on the retention and selection of directors.

The first stream is characterized by research into the extent to which boards are passive tools of management interests. This stream is grounded in organizational behaviour and according to the authors is concerned with the balance of non –executive to executive directors and the separation of the roles of chief executive officer and chairman of the board. This line of research concludes that composition of the board is determined largely by the powerful individual CEOs who co-opt existing directors and influence the retention of existing directors who are more likely to be supportive of the interests of the CEO (Zajac & Westphal, 1996).

There thus appears to be clear justification for the recommendation that the appointment of directors should be under the control of the non –executive directors. The question one needs to ask though is the extent to which the CEO is able to influence the non –executives in spite of his non –attendance on the nomination committee.

The second stream of research identified by the above authors is aimed at analyzing the macro structure of the board and the impact of interlocking directorships on the relationships between the organizations (Zajac & Westphal, 1996).

The third perspective is based on the agency view of boards as generally effective yet imperfect at serving shareholder interests (Fama, 1980). In terms of this financial

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economics perspective the directors attempt to develop and maintain a favourable reputation as active promoters of shareholder interests in an attempt to gain approval for appointments on other boards thus benefiting from their human capital.

King II (2002) has made recommendations that rely on the financial economic perspective of the director. In the section on "Compliance and Enforcement" the committee proposes that a register of delinquent directors be established and which is to be maintained by the Registrar of Companies and disclosed on its website. (147, 7.1). The thinking is that "peer pressure can then be exerted by organized business and the financial press against delinquent directors" (152, 4).

This suggestion will only succeed in an environment that is entirely free of protectionism and non-threatening reciprocal arrangements.

4.3. Remuneration Committees

Although the samples are not very comparable the results set out in chapter three above, compare very favourably, from a good governance point of view, with those in the research conducted by Ezzamel & Watson (1997a). Executive directors dominated the boards surveyed by Ezzamel & Watson. The CEO and chairman were also not separate individuals in 23% of their sample. In 33% of the cases the chairman was a member of the remuneration committee. Non–executive directors chaired only 47% of companies in the Ezzamel & Watson sample (p. 78 –79).

Although there is a space of four years between the research of Ezzamel & Watson and the South African sample is very small, it is pleasing to note that in the sample of six companies, except for one company in 1999, all companies had non-executives chairing their remuneration committee. Once again the true independence of the non-executive chairman was not established. *King II* is unambiguous in its recommendation that independent non-executives should be in the majority of the remuneration committee and that an independent non-executive should hold the chairmanship.

The role of <u>independent</u> non–executive chairmen in remuneration committees may be questioned in the South African context of "collegialism" on the basis of the "strong social influence considerations" Ezzamel & Watson (1997a). In South Africa it is possible that many of the non-executive directors sit on each other's remuneration committees. There may thus be a vicious circle or feedback loop in this exclusive club which has the effect of establishing an upward spiraling level of remuneration. *King II* has not addressed the concerns around reciprocal arrangements that may exist in the ranks of directors. It is entirely possible in the South African context of interlocking directorships and institutional shareholdings that reciprocal arrangements will exist between directors which, in effect, thwart the true independence of the non-executive directors and result, for example, in a "bidding up" of directors remuneration.

In this environment any recommendations on governance structures will also not do much to improve the level of governance or keep executive remuneration in check.

One consolation is that this trend is not entirely unique to South Africa. The trend of reciprocal beneficial independent non-executive directorships has been identified by Ezzamel & Watson in their research in the United Kingdom and was referred to by these researchers as the "cosy collusion" between directors (1997a. p.71).

4.4. Structures Not Necessarily the Answer

Bruce and Buck (1997) in their research into executive remuneration make the useful distinction between those institutional or structural measures that aim to ensure goal congruence between shareholders and management, and those measures that are specific to the executive's employment contract. In short, examples of the former would include the appointment of independent non-executive directors, establishment of remuneration committees and the separation of the roles of chairman and chief executive officer. An example of the latter would be the introduction of well-researched executive stock options. Bruce and Buck (1997) are sceptical about the success of structural mechanisms in ensuring goal alignment. The researchers conclude that the privileged access which the executives have to company information, their control over non-executive board appointment, and the "outsider" status of institutional shareholders as the major barriers to effective governance systems.

It is also worth noting that the recommendations of *King II* and the recommendations of committees in the United Kingdom are all primarily focussed on, to use Pettigrew and McNulty's (1995) words, "rules, regulations, institutional practises and structures which provide a framework for managerial accountability". These attempts at ensuring good governance do not address the actual behavioural dynamics and attitudes of independent non-executive directors. In many respects these latter ingredients are as import to good governance as the structural issues.

4.5 Summary

There appear to be differing opinions on whether or not corporate governance structures really do achieve the objectives behind their introduction. *King II* has called for a greater role to be played by independent non-executive directors. If the recommendations of *King II* are to be believed, these independent directors will play an important role in balancing the interests of all stakeholders. Research has, however shown that once a certain proportion of non-executive directors in reached on the board the benefits of having these directors present is no longer achieved. There is also research, which indicates that where an "unbalanced board" exists this is often identified by institutions, which acquire such companies and which then "rebalance" the board.

Chapter 5

Recommendations and Conclusion

5.1 Introduction

A great distinguishing feature of *King II (2002)* is that the committee has not only made recommendations on governance structures and principles but that it has also devoted much time to an investigation of the enforcement of these structures and principles. The following recommendations are drawn from both *King II* and the academic research referred to above.

5.2 Recommendations

Corporate Governance is not a piecemeal exercise. The broader benefits of good governance and the enhancement of shareholder value are only enjoyed when all the characteristics of good governance are adhered to on a continuous basis. Corporate governance is thus, in the opinion of this author, more about the attitude of leadership and motives behind decisions as opposed to ensuring that the company is managed by means of prescribed structures. The structures are designed to ensure that mechanisms exist which would support thorough debate, transparency and the correct decisions by people who hopefully have the right attitude and pure motives.

This is recognised in *King II* (2002) by the quotation of *The Business Roundtable, USA*:

> "...the substance of good governance is more important that its form; adoption of a set of rules or principles or of any particular practice or policy is not a substitute for, than does not itself assure, good corporate governance" (2002, 142).

The overall philosophy adopted by *King II* is, as has been demonstrated, based on the Stakeholder Model of corporate governance. This has resulted in an extremely comprehensive report that is certainly in line with modern business management theory. Of course, the big danger of adopting such an approach is that the accountability of management to everyone may in fact lead to the ultimate accountability of management to no one. This has been recognised by *King II* in that the committee has emphasised the role to be played by institutional shareholders in the enforcement of the corporate governance code. Whether shareholders will actually fulfil this role is not entirely certain. The research conducted in the United Kingdom indicates that institutional shareholders are loath to involve themselves in management of the companies in which they have invested. On the other hand, many institutional investors (*Hermes Investment Management* being the but one of many quoted in this dissertation) are beginning to codify what they expect of the management of the companies in which they are investing. In South Africa we have not seen institutional shareholders adopt a public stance on the level of governance that they expect from the companies in which they invest. *King II* has specifically referred to these institutions and has recommended that investment analysts investigate the extent to which companies have complied with the recommendations of *King II* before deciding to invest in such companies (2002, 143).

A recommendation that has also been made is that a "rating agency" be established in South Africa in order to publicly measure and compare the compliance of relevant companies to *King II*. Although certain South African accounting firms have made attempts at this the author's view is that there is not large-scale support for these "in-house" initiatives. What is required is the establishment of an entirely objective institution such as *Demicor Rating*, which operates throughout Europe and bases its solicited rating scale on that of the International Corporate Governance Network, the World Bank Code and code of the OECD (Caprasse, 2001). This South African body should be funded by either the JSE or corporate South Africa and should then, in the author's opinion, have a greater chance of success.

King II has correctly pointed out that to include such a body within the JSE would limit its jurisdiction to listed companies only whereas the actual code has been compiled to apply equally to large privately held companies. Given this limitation the Registrar of Companies may be the correct body to assume the role of "rating agency" this would certainly fit neatly with the *King* II recommendation that this government department should maintain a register of delinquent directors. For this to be possible the government would need to spend a huge amount on the resourcing the office of the Registrar. This could easily be funded by a once of levy on all South African corporations which have, for example, more than 50 employees or are publicly listed companies.

In addition to the South African educational system should be greater attention, at secondary and tertiary level, to the education of South African school children on the roles of various stakeholders in the modern corporation. This shareholder education programme should ultimately encourage South Africa's individual shareholders to play a more active role in companies in which they have invested. This it is felt is particularly important given the recent demutualisation of Old Mutual and Sanlam, which created thousands of first time shareholders, and the increased ease, often electronically, with which the average South African is able to invest in JSE listed companies.

Finally the issue of cross-directorships, which create the potential for "cosy collusion", should be formally addressed within South Africa. This problem, as has been indicated above, is not unique to South Africa but may be far worse in South Africa than in the western world due to South Africa's many years of isolation. This isolation, it is submitted, has resulted in a few large financial institutions, and by analogy, individuals controlling a huge number of South African corporations in both an executive and non-executive capacity. The manner to address this issue is to limit the number of directorships which individuals are entitled to hold and to restrict individuals from holding cross directorships.

5.3 Conclusion

South Africa probably has the most progressive and inclusive corporate governance code in the world. This is a remarkable achievement if one considers that all this has taken place in over a period of less than a decade. The current socio-political environment, including legislation aimed at addressing the inequalities of the past and disparity in wealth, should serve to further broaden the involvement of all South Africans in matters of national interest such as corporate governance. South Africa's rich cultural diversity and the inclusive philosophy of '*Umuntu ngumuntu ngabantu*' should ensure that in the long term the interests of shareholders and all other stakeholders are balanced to the benefit of all. In order to ensure the above corporate South Africa should play a more active role in educating South Africans on basic corporate governance principles and the roles and responsibilities of stakeholders in the corporate world.

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