ASSESSMENT OF CORPORATE GOVERNANCE REPORTING IN THE ANNUAL REPORTS OF SOUTH AFRICAN LISTED COMPANIES

by

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PSALM OF PRAISE

UJehova *ungumalusi wami, angiyikuswela lutho. Uyakungilalisa emadlelweni aluhlaza; uyakungiyisa ngasemanzini okuphumula. Ubuyisa umphefumulo wami ekulahlekeni; ungihola ezindleleni zokulunga ngenxa yegama lakhe elingcwele. Noma ngihamba esigodini sethunzi lokufa, angesabi okubi, ngokuba wena msindisi wami unami, intonga yakho nodondolo lwakho ziyangiduduza. Ulungisa itafula phambi kwami ebusweni bezitha zami; ugcoba ikhanda lami ngamafutha; indebe yami iyachichima. Impela okuhle nomusa kuyakungilandela imihla yonke yokuphila kwami; ngiyakuhlala endlini* ***kaJehova*** *kuze kube phakade. (Amahubo 23.)*

The LORD *is my shepherd; I shall not want. He maketh me to lie down in green pastures; he leadeth me beside the still waters. He restoreth my soul; he leadeth me in the paths of righteousness for his name's sake. Yea, though I walk through the valley of the shadow of death, I will fear no evil; for thou art with me; thy rod and thy staff they comfort me. Thou preparest a table before me in the presence of mine enemies; thou anointest my head with oil; my cup runneth over. Surely goodness and mercy shall follow me all the days of my life; and I will dwell in the house of* ***the LORD*** *for ever. (Psalm 23.)*

GLORY TO GOD IN THE HIGHEST

Glory to God in the highest, and peace to his people on earth. Lord God, heavenly King, almighty God and Father, we worship you, we give you thanks, and we praise you for your glory. Lord Jesus Christ, only Son of the Father, Lord God, Lamb of God, you take away the sin of the world: have mercy on us; you are seated at the right hand of the Father: receive our prayer. For you alone are the Holy One, you alone are the Lord, you alone are the Most High, Jesus Christ, with the Holy Spirit, in the glory of God the Father. **Amen.**

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DECLARATION

I, Steven Tankiso Mthokozisi Moloi, declare that ***"ASSESSMENT OF CORPORATE GOVERNANCE REPORTING IN THE ANNUAL REPORTS OF SOUTH AFRICAN LISTED COMPANIES"*** is my own work and that all the sources that I have used or quoted have been indicated and acknowledged by means of a complete list of references.

STM MOLOI	2008-11-10
Signature	Date
(Mr S T M Moloi)	

SUMMARY

Title of dissertation:

ASSESSMENT OF CORPORATE GOVERNANCE REPORTING IN THE ANNUAL REPORTS OF SOUTH AFRICAN LISTED COMPANIES

This dissertation reflects the results of a study during which the 2006 annual reports of the top-40 JSE listed companies, were assessed for their disclosure of the required corporate governance statements. Content analysis was used to identify the information.

The results obtained indicate that the majority of the JSE's top-40 listed companies adhere to good corporate governance disclosure practices. However, there are areas in which the non-disclosure of information was prevalent. These include the disclosure of information on the selection of external auditors and whistle blowing. Future research, employing sources such as SENS announcements, press releases, trading updates, cautionary announcements and websites together with annual reports should be conducted.

Key words:
Corporate governance disclosures, accounting, auditing, risk management, internal controls, board of directors, annual reports, top-40 JSE listed companies and King report.

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND TO THE STUDY

Corporate governance has its origins in the 19th century and arose in response to the separation of ownership and control, following the formation of common stock companies (Berle & Means 1932). The separation between ownership and control resulted in the agency relationship which refers to the situation where shareholders own the firm while managers control it.

In practice, managers do not always pursue the best interests of the company, but rather their own interests. This situation leads to the agency problem, which forms the theoretical framework for current corporate governance practices. The existence of the agency problem results from the owner's inability to run the company on a day-to-day basis. Managers are hired to manage the affairs of company owners, with the instruction of pursuing the owners' objectives. Deviation from these objectives and instructions results in the agency problem.

Good corporate governance is used as a measure for alleviating the agency problem, where the board of directors is regarded as the focal point of the governance system and therefore is accountable to shareholders and responsible for the performance and the affairs of the company (IOD 2002).

According to the Organisation for Economic Cooperation and Development (OECD) (1999 & 2004), corporate governance is the system by which business corporations are directed and controlled. This definition outlines the sets of procedures and policies that need to be followed by management and other stakeholders to assist the organisation in achieving its goals.

The sets of procedures and policies in turn promote accountability and transparency, in turn reducing the temptation for opportunism as management and employees of a company are exposed to the consequences/penalties of failure to adhere to the procedures and policies of the company (OECD 1999 & 2004). Failure by senior managers to apply good corporate governance practices has led to high profile failures such as the demise of Enron, the giant energy company in the United States, and other corporate failures in the world. These failures have placed the agency relationships in the spotlight. As a result of these failures, stakeholders began to work towards the common goal of fighting corruption and demanding transparency and accountability in the management of their organisations (Naidoo 2002).

Owing to the demise of Enron and other high profile corporate failures, corporate governance has become a significant topic in the business world and corporate governance statements have become one of the important disclosures in the company's annual report. An example of the above is the Johannesburg Securities Exchange (JSE), which amongst other corporate governance watchdogs in South Africa, requires full disclosure of all minimum corporate governance requirements, based on the King code of good corporate practices (Malherbe & Seagal 2001).

Much has been done to improve the level of corporate governance compliance in the world. Examples of these improvements are the regulations based on the King I and II reports (IOD 1994 & 2002) in South Africa, the Cadbury report in the United Kingdom (Cadbury 1992), the German Corporate Governance Code (GCGCGC 2006), the Organisation for Economic Cooperation and Development's principles of corporate governance (OECD 1999 & 2004) and the Sarbanes-Oxley Act of 2002 in the United States (One Hundred Seventh Congress of the United States 2002). The South African government has strengthened corporate governance by legalising some of the recommendations made by the King II report (IOD 2002) in the Corporate Laws Amendment Act, 2006 (RSA 2006). Section 3.4 of Chapter 3 discusses these aspects in detail.

The evidence in monitoring corporate governance reporting in South Africa is given by Deutsche Bank's 2003 corporate governance survey (Deutsche Bank Securities Incorporated 2003), the KPMG survey on corporate governance annual report disclosure practice (KPMG 1997/1998) and KPMG's survey of integrated sustainability report (KPMG 2006), amongst other surveys that have been undertaken.

According to Deutsche Bank Securities Incorporated (2003), corporate governance in South Africa has improved and most companies, particularly listed companies, take corporate governance seriously. However, the main concern of the survey is that there is no full compliance with the King code of good corporate practice. This is because most South African companies comply with the requirements but not with the spirit of good governance, for example, the survey cites the inability of companies to provide inside information about company practices i.e. the information on how directors are evaluated is not normally disclosed in annual reports (Deutsche Bank Securities Incorporated 2003).

KPMG's 2006 survey of integrated sustainability reporting (KPMG 2006) in South Africa covered 141 companies listed on the JSE All Share Index. The results of the survey demonstrated that there were many JSE listed companies developing King II checklists and ticking off compliance without necessarily buying into the spirit of good corporate governance (KPMG 2006: 2).

The KPMG and Deutsche Bank Securities Incorporated surveys suggest that corporate governance reporting in South Africa has improved overtime. Weaknesses in the framework are, however apparent and despite the combination of governance codes, the constitution of board committees, involvement of both non-executive and independent non-executive directors, enhanced oversight of accountants and auditors, tight Johannesburg Securities Exchange (JSE) listings requirements, government regulations and encouragement of shareholder activism, corporate governance compliance failures continue to occur (IOD 2002). An example of corporate governance weakness in South Africa was exposed in 2005 with Brett Kebble's prowling of Johannesburg Consolidated

Investment Companies Limited (JCI). This incident points to the fact that buccaneer/serious threats to shareholders' capital are found in the boardroom (Randgold 2005). The recent 2007 Fidentia scandal confirmed these weaknesses when billions of Rands went missing from the company's accounts (Business Report 2007b).

The surveys mentioned above indicate that companies are failing to comply with corporate governance requirements. It therefore appears that the corporate governance surveys undertaken were mostly concerned with the compliance of companies with corporate governance disclosures in their annual reports, which in a sense means that these surveys are testing compliance disclosure. This dissertation seeks to provide another perspective, by assessing whether corporate governance statements disclosed in the annual reports of listed companies improve the usefulness of these annual reports and whether they provide useful information which promotes sound decision making by users.

1.2 PROBLEM DEFINITION AND SUB-PROBLEMS

1.2.1 Problem statement

Corporate governance in South Africa gathered momentum after the 1994 King I report (IOD 1994). The main problem to be investigated in this study is the assessment of whether current corporate governance statements disclosed in South African listed company's annual reports provides useful information for users' decision making.

1.2.2 Sub-problems

In order to assess corporate governance reporting in the annual reports of the South African listed companies, this dissertation will:

- Place corporate governance within a theoretical framework by discussing agency theory, agency costs and the agency problem.
- Discuss past and present corporate governance practices in Germany, the United Kingdom, the United States and South Africa.
- Compare past and present corporate governance practices in Germany, the United Kingdom, the United States and South Africa.
- Discuss the South African corporate governance framework.
- Assess whether corporate governance statements disclosed in the annual reports of listed companies advance the usefulness of the annual reports for sound decision making by stakeholders.

1.3 REASONS FOR THE RESEARCH

As discussed in section 1.1 above, surveys on corporate governance in South African companies have been undertaken in recent years by companies such as KPMG (KPMG 1997/98 & 2006) and Deutsche Bank Securities Incorporated (Deutsche Bank Securities Incorporated 2003). These surveys addressed the question of compliance with corporate governance. However, the usefulness of information disclosed as corporate governance in the annual reports of the surveyed companies was not assessed for its usefulness for decision making. The surveys identified several areas of concern, such as the ticking off of compliance checklists, designed by the companies without actually promoting the spirit of good governance. For the latter reason, this dissertation seeks to, other than testing corporate governance compliance; provide an alternative by assessing the usefulness of corporate governance information disclosed in the annual reports of South African listed companies. Sound corporate governance practices are paramount to capital investment, particularly for developing countries like South Africa which need to attract foreign direct investment (FDI) (IOD 2002).

Further justification for this study is the importance of corporate governance disclosures in annual reports, as most users of financial information rely on audited annual financial statements to make informed decisions regarding their capital investment. The disclosure of verified minimum corporate governance statements in annual reports enhances stakeholders' knowledge of activities taking place within companies. The amendment of the Company's Act, 1973 (RSA 1973) to incorporate some of the King II recommendations on corporate governance in South Africa, is a major step towards corporate governance regulation in South Africa.

Listed companies will no longer only need to comply with the JSE's listings requirements and the recommendations of the King II report (IOD 2002), but rather by disclosing all minimum corporate governance statements in their annual reports, they will now also comply with the Corporate Laws Amendment Act, 2006 (RSA 2006). Failure to disclose the required information will be a violation of both the JSE's listings requirements and the Corporate Laws Amendment Act, 2006 (RSA 2006). The critical analysis of corporate governance information disclosed in annual reports is of importance, because this information reflects the willingness of companies to disclose corporate governance statements in their annual reports, reflecting in turn their respect for the country's laws, thus avoiding significant fines for non-compliance.

1.4 RESEARCH OBJECTIVES

The main objectives of this research are to analyse the information disclosed as corporate governance statements in companies' annual reports and to determine whether such information provides users of the annual reports such as government agencies, creditors, suppliers, employees, communities, shareholders, potential employees, potential investors and all other stakeholders of the companies with adequate information to make informed decisions regarding the affairs of the companies, as per the requirements of the Corporate Laws Amendment Act, 2006 (RSA 2006) and the recommendations made by the King II report (IOD 2002).

Assessment of corporate governance information will assist users to determine if corporate governance statements disclosed in annual reports are complete, partly complete or incomplete. Complete information will enhance sound decision making by users, because they will be acting from a well-informed platform. Incomplete and partly complete information will disadvantage users as they will not be aware of some of the activities which take place in the companies under scrutiny.

As annual reports are deemed the official communication between managers (insiders) and stakeholders (outsiders), managers are held accountable for the accuracy of all the information appearing in annual reports. In this way, by assessing the usefulness of information disclosed in annual reports for decision making, this research seeks to provide users of annual reports with a device to screen the information disclosed, thus protecting their interests in a company.

1.5 RESEARCH METHODOLOGY

The research will be conducted in two phases. The first part will be based on a literature study of the subject of corporate governance. This part covers the agency theory, problems and costs, the historical development of corporate governance and current corporate governance practices, the corporate governance framework in South Africa, and the research design that discusses the content analysis and the development of a research instrument (checklist).

The second part of this study is based on the empirical evidence gathered by means of using the checklist questions. The empirical evidence on the disclosure of corporate governance statements by the JSE's top-40 companies is tabulated and presented using the global classification system of companies (JSE 2004).

The checklist questions will be designed to take into account the minimum corporate governance disclosure requirements recommended by the King committee, with some of these recommendations now incorporated in the Corporate Laws Amendment Act, 2006 (RSA 2006). The research instrument (checklist) questions are based on:

- the board and its directors;
- risk management and internal controls;
- internal audit;
- integrated sustainability reporting;
- accounting and auditing;
- relations and communication with company shareholders; and
- the company's code of ethics (IOD 2002).

1.6 SCOPE

Corporate governance practices of companies are disclosed in their annual reports and in company websites. This research will reflect on corporate governance reporting practices in South Africa which will be limited to the assessment of the top-40 JSE listed companies. Assessment of corporate governance disclosures of the top-40 JSE listed companies will be based on the questions incorporated in the checklist designed.

The checklist questions have been designed in accordance with the minimum corporate governance disclosures as recommended by the King II report (IOD 2002) and the Corporate Laws Amendment Act, 2006 (RSA 2006). Corporate governance information for companies will be extracted directly from their 2006 annual reports obtained from the JSE's top-40 index, based on market capitalisation as quoted by I-Net Bridge on the 17th of October 2007 (I-Net Bridge 2007). Investor-Words (2008) defines market capitalisation as a "measurement of corporate or economic size of a company and is equal to the share price times the number of shares outstanding of a public company".

1.7 LIMITATIONS OF THIS RESEARCH

This research will assess the corporate governance reporting in the annual reports of South African listed companies, but the assessment will be limited to the top-40 listed companies based on the market capitalisation. Justification for the limitation of this study to the company's annual report is that the annual report is the most important stakeholder's document produced by a company on an annual basis. Any organisation committed to promoting and maintaining good corporate governance should use its annual report to communicate this to its shareholders and to the public in general. The annual report should provide the first impression of a company's corporate governance compliance.

A discussion of the history of corporate governance in the world is a study on its own. For this reason this study will provide a concise overview of the historical development of corporate governance in only Germany, the United Kingdom (UK), the United States (US), and South Africa. The reason for limiting the overview of the historical development of corporate governance to Germany, the UK and the US is the fact that these countries can be regarded as three of South Africa's main trading partners. International trade in 2003 between South Africa and these countries in terms of merchandise exports amounted to R256 billion, while gold exports amounted to R35 billion. Goods exported consisted of gold, other minerals and metals, agricultural products, motor vehicles and parts. In the same year, South Africa imported merchandise to the value of R263 billion. Goods imported consisted of machinery, transport equipment, chemicals, petroleum products, textiles, and scientific instruments. The major suppliers of these goods were Germany, the US and the UK (United States Bureau of African Affairs 2007).

Another limitation of this study is that the Company's Bill of 2007 (RSA 2007) is not discussed in detail. The reason for this is that the study is based on the 2006 annual reports of the top-40 JSE listed companies, which would not have been affected by the new legislation. It is claimed that the Company's Bill, 2007 (RSA 2007) represents a significant departure from the existing statute and is positioned to modernise the Companies Act of 1973 (RSA 1973) by aligning it with international jurisdictions and post-1994 South Africa.

1.8 STRUCTURE OF THE RESEARCH

The remainder of this dissertation is organised into the Chapters as outlined below.

Chapter 2: Theoretical framework

Chapter 2 discusses the agency theory, agency costs and the agency problem which are regarded as the theoretical framework for corporate governance. This is followed by a concise overview on the historical development of corporate governance in Germany, the UK, the US, and South Africa. Current corporate governance practices are placed into the context on which the remainder of this study rests.

Chapter 3: Corporate governance in South Africa

Chapter 3 gives an overview of the corporate governance framework in South Africa. It further discusses corporate transgressions, the Companies Act of 1973, Corporate Laws Amendment Act of 2006; progress of the Company's Bill, the King I, King II and King III reports on corporate governance and the requirements for listing on the Johannesburg Securities Exchange.

Chapter 4: Research design

Chapter 4 discusses content analysis as an instrument for assessing the annual reports of the top-40 JSE listed companies. It also discusses the minimum corporate governance disclosure requirements as per the King II recommendations and the Corporate Laws Amendment Act of 2006. Based on the requirements stipulated in the above documents, a checklist for corporate governance disclosures in the annual report of companies will be developed.

Chapter 5: Analysis of research findings

Chapter 5 assesses the quality of corporate governance reporting in the annual reports of South Africa's listed companies. The assessment will be done by analysing the usefulness of corporate governance disclosures for the process of economic decision making by users. Based on the minimum corporate governance disclosures discussed in Chapter 4, the annual reports of the top-40 JSE listed companies will be measured for their compliance with these requirements and the usefulness of these disclosures will be assessed using qualitative content analysis.

Chapter 6: Summary, recommendations and conclusion

This Chapter summarises the theoretical framework, the development of corporate governance, as well as the findings of the empirical evidence obtained in the assessment of corporate governance reporting in South Africa. It further provides recommendations for developing an alternative instrument that will contribute to the user analysis of annual reports in the process of sound decision making. This Chapter also presents suggestions for future research.

1.9 LIST OF ACRONYMS USED

Below is a list of the acronyms used in this dissertation.

AA	Affirmative Action
BCEA	Basic Conditions of Employment Act
BEE	Black Economic Empowerment
CEO	Chief Executive Officer
CFO	Chief Financial Officer
COSO	Committee of Sponsoring Organisation of the Treadway Commission
EE	Employment Equity
FASB	Financial Accounting Standards Board
FDI	Foreign Direct Investments
FSB	Financial Services Board
GAAP	Generally Accepted Accounting Practice
GCGCGC	Government Commission on German Corporate Governance Code
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
ICAEW	Institute of Chartered Accountants of England and Wales
ICMM	International Council on Mining and Metals
ICSA	Institute of Chartered Secretaries and Administrators
IFRS	International Financial Reporting Standards
INC.	Incorporated
INTOSAI	International Organisation of Supreme Audit Institution
IOD	Institute of Directors
JSE	Johannesburg Securities Exchange
LSE	London Stock Exchange
LRA	Labour Relations Act
NBER	National Bureau of Economic Research

NEMA	National Environmental Management Act
OECD	Organisation for Economic Cooperation and Development
PARA.	Paragraph
PARAS.	Paragraphs
PCAOB	Public Company Accounting Oversight Board
PFMA	Public Finance Management Act
PwC	PricewaterhouseCoopers
SAICA	South African Institute of Chartered Accountants
SEC	Securities Exchange Commission
SEC.	Section
SECS.	Sections
SECA	Stock Exchange Control Act
UK	United Kingdom
UNECE	United Nations Economic Commission for Europe
US	United States

CHAPTER 2

THEORETICAL FRAMEWORK

2.1 INTRODUCTION

‘Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.’ (IOD 2002: 5 & Cadbury 1992).

The above definition of corporate governance as described by the IOD (2002: 5) and Cadbury (1992) sets out the objectives to be reached by applying good corporate governance practices. The objectives of a company include, amongst other things, the procedures and policies which ensure that the directors and management of the company maximise shareholder value, minimise the risks of self-opportunism by individual employees by putting strong internal control systems in place and minimising the damages to the environment in which the company operates.

The agency theory, agency problem and agency costs form the theoretical framework for this Chapter. To be able to place corporate governance in South Africa into context, the historical development of corporate governance in South Africa and three of its major trading partners, Germany, the UK, and the US, is discussed below.

2.2 THE AGENCY THEORY, AGENCY PROBLEM AND AGENCY COST

2.2.1 The agency theory and the agency problem

The agency theory is concerned with understanding the consequences and solutions caused by the conflict of interest which arises because of the separation of ownership and decision-making authority (control) in the company. In the *Modern Corporation and Private Property,* Berle and Means (1932) emphasise the agency theory by explaining the separation of ownership and control. Since this pioneering work appeared, the literature on agency theory has been based on the separation of ownership and control in a company.

In their publication, *The Theory of the Firm,* Jensen and Meckling (1976) examined the relationship between principals and agents in a company. Their seminal work proposed the theory of the firm based upon conflicts of interest between various contracting parties, namely shareholders, managers and debtholders. An enormous body of knowledge has been developed to explain both the nature of these conflicts as well as the means by which these conflicts can be resolved. To fully summarise all of the research that has been conducted on the agency theory would require a study in its own right. This research provides a summary of the major research findings that have emerged concerning the key issues in terms of the causes of agency conflicts.

According to Jensen and Meckling (1976), two agency relationships exist. The first of these is the manager-shareholder relationship and the other is the shareholder-debtholder relationship. The explanation of the two agency relationships identified by Jensen and Meckling (1976) is given by Godfrey, Hodgson, Homes and Kam (1992). According to them (1992), the debtholder is the principal and the shareholder is an agent in the shareholder-debtholder relationship. In the manager-shareholder relationship, a manager controls the firm on behalf of the shareholder, this results in a manager acting on behalf of the shareholder. As a result, a shareholder is a principal and a manager is an agent who carries a mandate for the shareholder (Godfrey *et al* 1992).

Similar to Jensen and Meckling (1976), Tiessen and Waterhouse (1983) believe that the agency theory is developed around the concept of contractual relationships between two groups with conflicting objectives, i.e., principals and agents. For Tiessen and Waterhouse (1983), the main objective in agency theory is to structure the contractual relationship between these conflicting groups so that agents take actions to maximise the interests of a principal (this is called goal congruence) (Tiessen & Waterhouse 1983).

The agency theory relationship discussed above is also examined in detail by Eisenhardt (1989). According to Eisenhardt (1989), agency theory refers to the ever-present agency relationship in companies, where one party (the principal) delegates work to another (the agent), who has to perform that work, i.e. the principal mandates the agent to do a certain task and the agent is remunerated for that task. Eisenhardt (1989) argues that under conditions of imperfect information and uncertainty, which is the situation in most companies, because of the complex shareholding, for example in public companies, two agency problems arises. These problems are known as adverse selection and moral hazard.

- The first problem arises when the desires or goals of the principal and an agent conflict and it is difficult or expensive for the principal to verify what the agent is actually doing. The problem here is that the principal cannot verify that the agent has behaved appropriately. Eisenhardt refers to this situation as adverse selection.
- The second agency problem arises when both the principal and agent have different attitudes towards risk. The problem here is that the principal and the agent may prefer different actions because of their differing risk preferences. This is known as moral hazard (Eisenhardt 1989).

The moral hazard and adverse selection problems are also observed by Stiglitz and Weiss (1981) in their credit rationing theory of banks. The core of the Stiglitz and Weiss model is based on the theory of asymmetric information. Information is said to be asymmetric if it is not freely available. This causes the information to be unevenly distributed among the agents (Stiglitz & Weiss 1981).

According to Stiglitz and Weiss (1981), asymmetric information will lead to adverse selection before the transaction takes place. This is a situation where projects that are not supposed to be funded by banks are actually funded and those that are supposed to be funded are not. After the transaction takes place and the wrongly-funded project gets underway, the problem of imperfect information then leads to moral hazard. This is the situation where the agent defaults and the bank cannot recover its initial investment or the interest payments that would have been recouped if the project had been successful (Stiglitz & Weiss 1981).

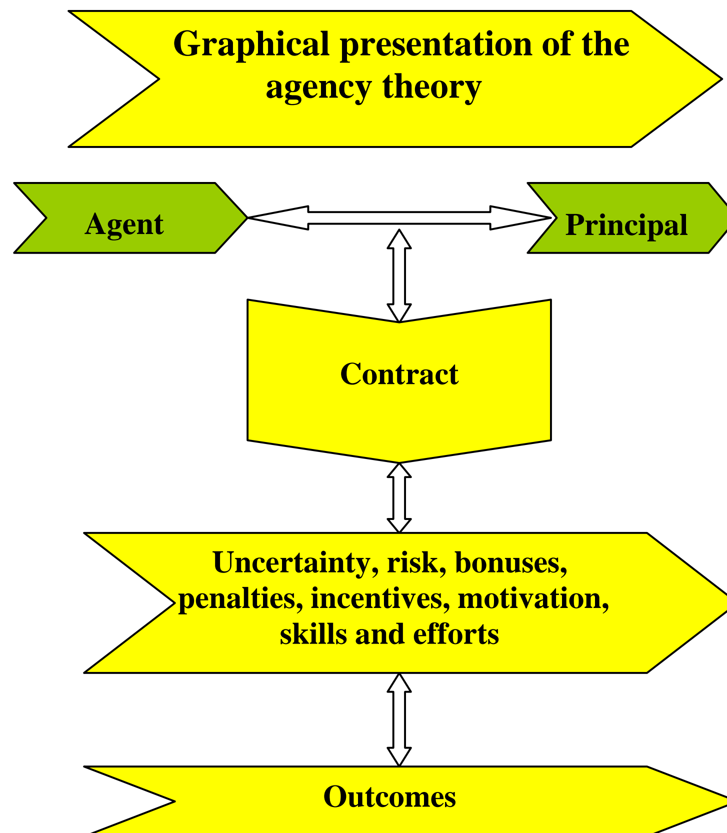
2.2.2 The agency theory and problem and corporate governance

Emery, Finnerty and Stowe (2004: 376) define the agency theory as "how to minimise the cost of having someone else making decisions on your behalf". This refers to the cost of managing a situation in which you have a stake, albeit, through other people. What is this cost of managing a situation? For Emery *et al* (2004) the answer lies in creating incentives, constraints and punishments, having reasonable monitoring procedures and identifying and using contracts, at the outset, that minimise the possibility of conflict of interests. Emery *et al* (2004) further note that the costs associated with financial contracts (agency costs) occur throughout the business decision-making process and that they can be significant.

The agency theory and agency problem discussed above identify the fundamentals of the corporate governance problem. The conflicting interests of the principal and the agent, these being the shareholders and managers of a firm, respectively, is the differing financial interests of these two corporate governance stakeholders. Management is interested in high salaries and bonuses whereas shareholders are interested in dividends, high profits and high cash flows (Tiessen & Waterhouse 1983).

From the above argument presented by Tiessen and Waterhouse (1983), the agency theory can be summarised using the following diagram set out in Figure 2.1.

FIGURE 2.1 – GRAPHICAL PRESENTATION OF THE AGENCY THEORY



The above figure was constructed by using the information obtained from Tiessen and Waterhouse (1983: 251-267)

Using the above diagram constructed based on the information taken from Tiessen and Waterhouse (1983), the assumption regarding the agency model of contract design and performance clauses has been questioned by several writers. Kaplan (1983) for instance questions whether managers engage in continuous utility maximisation or not. In the same vein, Perrow's (1981) concern is the fact that agency theory overlooks deception by principals and does not address the issues of shareholders' domination and authority.

Furthermore, Perrow (1981) contends that agency theory exaggerates the prevalence of opportunism, while it neglects good behaviour, and fails to consider how organisational slack and promotion policies, which take into account length of service, reduce the effects of adverse selection and moral hazard (Perrow 1981).

The suggestion by Kaplan (1983) and Perrow (1981) is that agency theory is a one-sided theory in its assumption of human nature, in other words, the agency theory sides with the principal. Tiessen and Waterhouse (1983) argue that although it has been suggested by the above writers (Kaplan 1983 & Perrow 1981) that the formal models of principal-agent relationships may be one-sided, because they focus on single-period behaviour, analyse complex relationships and overlook processes in hierarchies, such arguments have not been proven in the context of organisation theory.

As mentioned above in the presentation of the theory of Stiglitz and Weiss (1981), the outcome of uncertainty in an agency relationship will be closely associated with three factors:

- Moral hazard, where the agent may expend less than optimal effort,
- Adverse selection, where the agent may expend an inappropriate type of effort, and
- The state of nature, which is outside the control of both the principal and the agent.

From the above discussions, it is clear that uncertainty about the agent's effort to maximise shareholder value and uncertainty about the state of the nature of an agent lead to uncertainty about the outcome of the agency relationship. In a nutshell, the point that Kaplan (1983) and Perrow (1981) are making is that the agency theory has largely restricted itself to addressing the uncertainty associated with the agent's effort, ignoring the efforts made by the principal in the agency relationship, hence their “one-sided theory” argument.

Because of the complex agency relationships in a company and the attempts to improve corporate governance through reporting, developments in accounting, financial reporting and auditing have been designed to address the agency problem, thus providing protection for the investors in a company. These measures are taken to impose a duty of accountability and transparency upon the directors and managers of a company.

According to Smith and Keenan (1969), the imposition of the duty of care to managers when managing the affairs of shareholders was not seen to provide sufficient protection for potential and existing investors in a business enterprise. Potential and existing investors require adequate assurances that their capital will not be abused by corrupt company management. As a result of this, the UK Parliament in 1855 introduced the concept of limited liability. Limited liability means that the possible risk to any shareholder is the maximum of the amount paid for the shares plus any unpaid share capital. This liability is usually specified in detail in a memorandum of association of a company.

The origins of the principle of limited liability can be traced to the UK, where the Limited Liability Act of 1855 was passed. According to Glautier and Underdown (1995), there was substantial opposition to the passing of the Limited Liability Act of 1855 by many members of parliament. However, Parliament later recognised the need to protect shareholders' funds in UK companies so as to attract potential investors to London. The UK Parliament recognised the potential for corporate abuse by people entrusted with safeguarding shareholders assets. They also acknowledged the requirements for stewardship and the fact that the disclosure of information to shareholders was linked to this limitation of liability, thereby protecting them as shareholders.

In legal terms, a company is a person with the power to make contracts, like any other individual, but the reality of the matter is that this power is vested in the directors and managers of the company. The consequence of this is that managers can enter into transactions for which they have no liability for non-fulfilment, thus resulting in an agency conflict.

The introduction of the Limited Liability Act of 1855, according to Glautier and Underdown (1995), transferred the risk referred above from the legal owners of a business to those with whom that business transacted. This meant that a manager, who entered into a transaction without the authority to do so, became liable in person to the transacted entity.

As a result of the above, the ability of managers to engage in transactions on behalf of the business, without any necessary evidence of ownership, meant that most risk was transferred away from the business. Given the risk resulting from the fact that managers have both the ability to commit the organisation to whatever contracts and transactions they feel appropriate and that they have a responsibility towards the owners of the business, the UK Parliament felt that there was a need to ensure that this responsibility was adopted. The result was the Limited Liability Act of 1855 (Glautier & Underdown 1995).

In countries where there are no acts similar to the Limited Liability Act of 1855, the agency theory provides a platform upon which managers can be made accountable for their actions. This is done in the form of agency contracts. As noted in the discussion of agency theory above, the theory suggests that management of an organisation is undertaken on behalf of the owners of the company, in other words the shareholders. As a result, the value created by the management of the organisation is only important as long as that value accrues to the shareholders of the company.

Based on the above discussion of the agency theory, it appears that managers should act as the custodians of the company and its operational activities on behalf of shareholders/company owners, who cannot run the day-to-day activities. The agency theory further places upon managers the burden of managing in the best interest of the owners of that business, since the main aim of the firm is to maximise the wealth of shareholders. This implies that the managers of a firm have to pursue the same objectives as the company owners.

However, as noted above, agency theory assumes that managers may divert from this aim and concentrate on job security and potentially higher salaries, which in a sense create agency conflict, since there are differing interests (Emery *et al* 2004: 380). The controls and incentives which shareholders incorporate to align differing interests between the principal and the agent come at a cost. These costs are referred to as agency costs (Correia, Flynn, Uliana & Wormald 2000: 20). The alignment of the differing interests of the principal and the agent lead directly to the agency cost.

2.2.3 The agency cost

Emery *et al* (2004: 379) define agency costs as "the incremental costs of working through others (agents)". Emery *et al* (2004) identify five basic agency costs. These five basic agency costs are outlined below as:

- The transaction costs of setting up a contract, i.e. commission and legal fees.
- The opportunity costs imposed by constraints on decision-making, i.e. foregoing potentially high returns because of associated unacceptable high-risk levels.
- The costs of incentives paid to encourage behaviour in line with the principal's objective.
- The costs of monitoring the agent.
- The loss of wealth due to misconduct, despite the monitoring, associated with excessive management expense accounts, unproductive time, fraud and negligence (Emery *et al* 2004).

According to Jensen and Meckling (1976), the agency relationship is defined as "a contract under which the principal engages the agent to perform the activities on their behalf". As part of the above, the principal will delegate critical decision-making authority to the agent.

Brennan (1995) argues that the agency problem arises because of the impossibility of perfectly contracting each and every possible action of an agent whose decisions affect both his/her own interests and the interests of the principal. The fundamental question arising from differing interests (the agency problem) is how to persuade the agent to act in the best interests of the principal.

The above question leads to the intense analysis of agency costs. Jensen and Meckling (1976) argue that as with any other costs, agency costs will be captured by financial markets and reflected in a company's share price. Agency costs in this context can be seen as the value loss to shareholders, arising from divergences of interest between shareholders and managers. According to Jensen and Meckling (1976) agency costs consist of monitoring costs, bonding costs and residual loss.

Monitoring costs are costs that are incurred when the principal is monitoring agents' behaviour, for example, audit costs. Godfrey *et al* (1992) emphasise that in the shareholder-debtholder relationship, monitoring costs are transferred via debt covenants, placing restrictions on investment, dividend and financing activities of an organisation. However, in the manager-shareholder relationship, these costs are transferred by adjusting the agent's remuneration package (or bonus plan) according to the perceived level of monitoring required (Godfrey *et al* 1992).

Because monitoring costs are borne by the agent, the agent will find a way to align its interests with those of the principal by setting up structures that will encourage them (the agents) to act in shareholders' best interests. The costs associated with finding these mechanisms are known as bonding costs. A good example of bonding costs would be the cost of additional information disclosures to shareholders and the cost of preparing financial statements for a company (Emery *et al* 2004).

Denis and Kruse (2000) argue that the optimal bonding contract should aim to attract managers into making all the decisions that are in the shareholders' best interests. Since managers cannot be made to do everything that shareholders want them to do, bonding costs provide a means of making managers do part of the things that shareholders need, by writing less than perfect contracts.

As a result of the above Jensen and Meckling (1976) agree that it is very costly to align the interests of shareholders and management completely. The costs incurred after monitoring and bonding costs are treated as residual loss. In a nutshell, residual loss arises because the cost of fully enforcing principal-agent contracts far outweighs the benefits derived from doing so. An agent acting in his/her own interests, at the expense of the principal, then transfers this "loss" to the principal (Jensen & Meckling 1976.)

According to Emery *et al* (2004: 380) corporate managers should act legally and in an ethically sound manner in pursuit of the goal of maximisation of shareholder wealth. Price fixing, insider trading, market manipulation and dishonest accounting are not in the company's long term best interests and should not be interpreted as the efforts to maximise shareholder wealth. It is greedy managers who benefit from these activities (Emery *et al* 2004).

Managers that are motivated by self-interest abuse their positions and those whose actions are against the objectives of the principal, even though their actions are not illegal, are also acting in an unethical and unacceptable manner. Since the costs of monitoring agents are very high, as Jensen and Meckling (1976) have demonstrated above, and because these costs are ultimately diverted to the principal, Emery *et al* (2004) suggest the following potentially cost effective monitoring devices:

- Audited financial statements — these serve as an early warning and a monitoring device for agency relationships.

- New external financing — if a firm requires external finance, it will have to reveal additional information, in turn exposing it to special scrutiny, which can be regarded as another form of monitoring.

- Cash dividends — the failure to declare cash dividends serves as a warning signal that a company is experiencing cash flow problems.
- Bond-ratings — bond-rating agencies provide monitoring when bonds are first issued and to a lesser degree over the life of a bond.
- Debt covenants — debt covenants may provide a kind of an early warning indicator to stakeholders and potential stakeholders. Negative covenants prohibit or limit certain actions, for example incurring further debts and paying dividends, while positive covenants require certain actions such as regularly making tax payments and providing interim financial statements.
- Government regulations — government agencies may monitor firms for various legal violations or actions that are not in the public interest.
- The legal system of a country — the entire legal system of a country provides various forms of monitoring and punishment for illegal behaviour such as theft and fraud.
- Reputation — a good reputation is a valuable asset and maintaining a good reputation serves as an incentive for providing accurate information, which is another form of monitoring.
- Multilevel organisations — many levels of authority for reviewing and evaluating also provide structures for monitoring, since misconduct is more difficult to conceal when a large number of people have access to information and decisions (Emery *et al* 2004).

Potential investors and other stakeholders in a company may look for the above combination of monitoring devices as well as compliance of a company with codes of good corporate practice for sound economic decision making. Agency theory provides a theoretical framework for corporate governance by explaining the problems caused by the separation of ownership and control, which is the basic corporate governance problem.

The remainder of this Chapter will give a concise summary of corporate governance development in Germany, the UK, the US and South Africa. Discussing the overall development of corporate governance in these countries is a study on its own and for the purpose of this dissertation, which is to highlight the important features of corporate governance in these countries, an overview of historical corporate governance and current practices in these countries, is given.

2.3 THE DEVELOPMENT OF CORPORATE GOVERNANCE

The intention of this section is to provide a concise overview of corporate governance in Germany, the UK and the US and to compare it with the development of corporate governance in South Africa. As mentioned in Chapter one, these countries have been selected on the basis that they represent three of South Africa's major trading partners. In addition to the above, the US experienced one of the biggest corporate scandals in history in the cases of Enron and WorldCom (Naidoo 2002). These cases provide valuable lessons.

Comparing the historical development and current corporate governance practices in these countries with those in South Africa will help to identify the problems that exist in South Africa's corporate framework and provide solutions by showing how problems were solved in these countries. Pro-active measures such as early warning systems to avoid massive corporate governance scandals can be identified by taking note of measures that countries, such as the US, have introduced to counter corporate scandals.

2.3.1 Germany

2.3.1.1 Short historical review

Germany's industrialisation advanced rapidly in the late 19th century, financed by wealthy merchant families, foreign investors, small shareholders and private banks. To avoid the self-opportunism of managers, the Company's Act of 1884 was established. This Act aimed to ensure accountability and transparency from people who were managing the affairs of shareholders. Up until that time, banks played a minor role and had little influence on German companies (Allen & Gale 2001: 81-120.).

The Companies Act of 1884 protected small shareholders and the general public from greed and corruption of those who put their own interests before the interest of the corporation (Fohlin 2004). Since companies had to comply with this Act, the recording of transactions became a uniform standard for all companies in German. The important feature with regard to German corporations is that these corporations used managers to manage the day to day operations of the corporation and supervisors who sat on the supervisory board of the company (Roe 2002).

Transparency became the order of the day in the early years of German corporate governance, for example, the Company's Act of 1884 prohibited sitting on two supervisory boards, to avoid conflict of interest, while companies were required to disclose this information in their annual reports. Some of the minimum corporate governance requirements in Germany required compliance by as early as 1884. The introduction of the Companies Act of 1897 allowed insider trading within German corporations, i.e. shares could be bought and sold by managers of the company to promote personal interest (Roe 2002).

According to Morck and Steier (2005), allowing the insider trading raised fear of corporate takeovers by managers, especially in companies that were founded by family members. As a result, family-founded companies pressed for the introduction of multiple voting shares, which would allow family members to bestow a family member who sat on supervisory boards with their shares, so that this family member (the one who has been bestowed with other family member's shares) could vote on their behalf and represent their interests within a company. The family members with seats on the supervisory board would thus have acted by proxy given by other family members (Morck & Steier 2005).

Following the multiple voting shares pressed for by family-founded companies, the revolution of Germany's bank proxy voting powers arose when companies passed their shares on to banks as collaterals for loans. Since the Company Law of 1884 required a minimum number of shareholders at the first meeting, Fohlin (2004) notes that banks easily accomplished and used this to their advantage by holding proxies for small shareholders. By passing the Company's Act of 1897 which allowed for insider trading, insider trading of shares became possible for banks. The shareholders' law of 1937 perpetuated this situation by banning shareholders from voting by post, forcing shareholders who could not vote personally to entrust the banks with their proxies. This allowed banks to have a greater influence in corporate affairs (Fohlin 2004). Fohlin (2004) acknowledges that just after World War I, banks in Germany were privatised, but they retained their proxy powers.

Corporate governance did not seem to be a problem in German history, firstly because private companies constituted the greater portion of German companies and secondly, because German companies did not have directors. Instead of directors they had managers and supervisors, the former (managers) managed the day-to-day operations of the business and the latter (supervisors) sat on the supervisory board. In addition, there has never been massive corporate fraud reported in Germany (Morck & Steier 2005), because of effective German company law. Massive bankruptcies have been avoided,

although there are examples of fraud cases, but in small companies, such as the Tech Bubble Scandal (Allen & Gale 2001).

2.3.1.2 Recent corporate governance reforms in Germany

The recent reforms of corporate governance in Germany were to ensure that events similar to the Tech Bubble (these were fraud cases involving small technology and internet firms) of the years 1998 to 2000 are never again repeated in Germany (Morck & Steier 2005). Corporate governance reforms included the strengthening of auditor independence and supervisory board powers in 1998. Between the years 1994 and 2002 the revision of the laws on shareholders' meetings weakened the influence of banks' proxy voting processes. All of these reforms were aimed at modernising German corporate laws (Morck & Steier 2005).

In 2001 the German Corporate Governance Code was passed by the Government Commission on German Corporate Governance Code (GCGCGC 2006). This code requires all listed companies to issue a declaration that they have complied with the code. The code is mandatory since companies have to comply or explain, which means that it puts pressure on companies to be more transparent. If a company cannot comply, it must provide an explanation of why it failed to comply (GCGCGC 2006).

Morck and Steier (2005) highlight the following three factors as the driving force behind Germany's current corporate governance reforms:

- The efforts to improve the European single market for financial services and products, for example the establishment of the European Union using a single currency, the Euro;
- International developments in the subject of corporate governance, particularly in the US where major bankruptcies took place in 2002 which led to the establishment of the Sarbanes-Oxley Act of 2002; and
- The adjustments in Germany's corporate governance rules and the establishment of the Germany Government Commission on Corporate Governance in 2001.

Morck and Steier (2005) argue that by implementing the German Corporate Governance Code, the German government believed that capital markets would become stronger, transparency in German corporations would prevail and it would also ensure that there would be strict criminal and civil actions against any individuals involved in corruption.

Finally, Morck and Steier (2005) identify three crucial areas of development in corporate governance practices in Germany:

- The first involves liability of corporate managers which gives the supervisory board the right to sue the manager should there be misconduct. Unfortunately, according to Morck and Steier (2005), supervisory boards rarely apply this right.
- The second area of development is the change in shareholders' meetings. Irrespective of whether the shareholder is a minority shareholder or majority, a shareholder can attend the Annual General Meeting (AGM) and has the right to ask any question with regards to voting. Failure to answer these questions leads to the dispute of the outcomes of the Annual General Meeting and any decision taken is then deemed null and void.
- The third area of development is a shareholder meeting decision whereby companies are advised to record all information on their websites so as to avoid having to answer many questions during annual general meetings (Morck & Steier 2005).

From the above it is clear that German authorities intervene in markets by responding to the challenges posed by the changing and demanding corporate governance environment. Corporate governance reforms in Germany are mainly aimed at protecting stakeholders and are mostly influenced by external factors, for example the driving factors noted by Morck and Steier (2005). These factors are a single market for financial services in Europe and international developments in corporate governance due to increased corporate failures which led to the establishment of the German Corporate Governance Code.

2.3.2 The United Kingdom

2.3.2.1 Short historical review

Franks, Meyer and Rossi (2004) acknowledge that corporate governance in the UK was weak in the first part of the 20th century, with shareholders playing a minor role in corporate issues. However, Sylla and Smith (1995) argue that as early as 1890 financial markets were already developed in the UK. To substantiate their argument, Sylla and Smith (1995) note the passing of the Directors Liability Act of 1890, which made a company director liable for statements in prospectuses soliciting buyers for company shares. To substantiate their argument of weak corporate governance in UK, Franks *et al* (2004) argue that the Companies Act of 1900 strengthened the principle of compulsory corporate disclosure, thereby strengthening corporate governance (Franks *et al* 2004).

According to Morck and Steier (2005) the UK's economy was comprised mainly of very risky companies known as pyramids firms. A pyramid structure is defined as "a structure in which an apex shareholder, usually a very wealthy family, controls a single company, which may or may not be listed. This company then holds control blocks in other listed companies". These pyramid firms gained importance in the middle of the 20th century. Proponents of these firms argued that these were a defence against hostile takeovers (Morck & Steier 2005).

In the 1960s institutional investors saw this kind of a firm as a risky business, because pyramid firms permitted corporate insider trading, which was against the good spirit of promoting transparency. The argument by investors was that British corporations were governed by higher standards of ethical conduct. Institutional investors lobbied to have the pyramid firms dissolved. Because of the pressure from institutional investors, British corporate insiders were more readily convinced to sell their control blocks and dissolve their pyramids. British institutional investors successfully pressed the London Stock Exchange (LSE) to adopt a takeover rule whereby any bid for 30% or more of a listed

firm must be a bid for 100% and this rule made pyramidal business groups untenable as takeover defences (Franks *et al* 2004).

Chandler (1990) highlights the fact that by the 1970s managerial enterprise was rapidly replacing personal and entrepreneurial capitalism in the UK. British industrial and commercial firms made a strong move towards public ownership. The complication in the UK was that most firms were dominated by families and they retained a large number of shares by the time they joined the stock market. This allowed families to play a major role in the stock market (Cheffins & Berwin 2001).

2.3.2.2 Recent corporate governance reforms in the United Kingdom

The following reports serve as the foundation of current practices in the UK's corporate governance; the Cadbury report of 1992; the Greenbury Report of 1995; the Hampel Report of 1998; the Turnbull Report of 1999; and the Higgs Review of 2003. The Cadbury report is one of the most recognised reports in the world and is viewed as being highly influential to the development of corporate governance in the UK (Jones & Pollitt 2003).

The Cadbury report (Cadbury 1992) recommended a self-regulation approach whereby reporting of compliance with corporate governance was part of the listing requirements for public companies. The report further emphasised the board as a focal decision point, the emphasis being on appropriately constituted board sub-committees (remuneration, audit and nomination), independent non-executive directors and the separation of the chairman and the chief executive positions (Cadbury 1992).

The Greenbury Report of 1995 was concerned with accounting for directors' remuneration in the UK corporations. The Hampel Report of 1998 consolidated the task started by the Cadbury Report and the Greenbury Report. The Hampel Report contributed by recommending what was later to be known as the Combined Code on Corporate Governance. This code was attached to the listing rules of the stock exchange with the requirement that in order to be listed, companies must either declare their adherence to its

provisions or explain any deviation from them. This is called the 'comply or explain' approach (Jones & Pollit 2003).

The Institute of Chartered Accountants of England and Wales (ICAEW 2005) notes that listed companies in the UK are required to provide non-financial disclosures to be in line with listing requirements. This is required by the combined Code on Corporate Governance, and an explanation of non-disclosure is required.

The Turnbull Report of 1999 followed the Hampel Report. It emphasised the importance of internal control, maintaining a sound system of internal control, reviewing the effectiveness of internal control, the board statement on internal control and the importance of internal audit. The Higgs Review of 2003 emphasised the effectiveness of non-executive directors, their recruitment and their independence in an organisation (Jones & Pollitt 2003).

Today most companies in the UK are publicly held and their annual financial statements (with the exception of small companies) have to be audited. The audit report has to state if the financial statements fairly present the state of affairs of the company at that particular period and are indeed in line with the Companies Act of 1985. This Act requires companies to keep proper records to help explain transactions (ICAEW 2005).

Based on the above, it appears that initially the emerging of multinational corporations in the US influenced the UK's corporate governance, because corporations in the UK moved away from family-controlled firms to publicly-owned firms. Further, it is apparent that corporate governance reforms in the UK have mainly been the work of the five reports discussed above, these being the Cadbury Report, the Greenbury Report, the Hampel Report, the Turnbull Report and the Higgs Review.

2.3.3 The United States

2.3.3.1 Short historical review

American corporations before the 20th century consisted of corporations that were controlled by powerful banks and family businesses. These powerful individuals used their influence to monitor managers, choose managers, set corporate directions and replace the managers of corporations when it suited them. Developments in the 20th century changed this as evidenced by the democratisation of shareholding in American corporations that took place between World War I and World War II (Moody 1904).

The development of corporate governance in the US can be traced to the 1929 Wall Street Crash, the 1929 to 1932 period of the Great Depression and World War II. The US experienced the emergence of multinational corporations more than any country in the world just after World War II. This led to the establishment of the managerial class. Corporations started to hire experienced corporate managers to run their business affairs (Chandler 1990).

According to Chandler (1990) publicly-held corporations were already directed by professional managers and owned by widely dispersed shareholders in the US by the 1930s. Share ownership was largely isolated among a large number of institutional and individual investors rather than being concentrated in the hands of family owners, banks or affiliated firms. Cheffins and Berwin (2001) emphasise the fact that stakeholders rarely took over in the running of a company and did not intervene and take a hand in running a business. Instead they maintained their distance and gave executives a free hand to manage the affairs of the business.

By the end of World War I family businesses were working closely with directors rather than managing businesses on their own. Family businesses were thus diluted to include the general public (Berle & Means 1932) and even though shareholders were treated as the owners of the company, they never interfered in the duties of management (this is the basis of separation of ownership and control). From the above, it is clear that the following events were pivotal in the history of American corporate governance:

- The 1929 Wall Street Crash;
- The 1929 to 1932 period of Great Depression; and
- The World Wars which led to the emergence of multinational corporations.

2.3.3.2 Recent corporate governance reforms in the United States

Three important events signalled the corporate governance reforms in the US. Firstly the dismissal of chief executive officers (CEOs) by companies such as IBM, Kodak and Honewell by their boards of directors, secondly the rise of activism amongst institutional investors, for example the California Public Employees' Retirement System (CalPERS) company, which is one of the largest purchasers of employee benefits, has in the past called for full corporate governance disclosures from the companies in which it has interests. Finally, the massive bankruptcies of Enron and WorldCom and small corporate debacles of companies like AOL, Tyco, Aldephia Communications and Global Crossing also served as catalysts for change (Naidoo 2002).

The above-mentioned corporate problems reflected a need to reform US corporate governance, because shareholders no longer had confidence in corporate reports. Although the US public had already been exposed to a corporate governance-related scandal as early as 1970, namely the Watergate scandal, the 2002 corporate governance scandals in Enron and WorldCom had a significant impact (UNECE 2002).

The American Congress responded to these corporate governance problems by passing the Sarbanes-Oxley Act of 2002. The New York Stock Exchange (NYSE) adopted the Act and required all listed companies to comply with it (UNECE 2002). The adoption of the Sarbanes-Oxley Act of 2002 reformed the US Companies Act. Section 303 of the Sarbanes-Oxley Act, for example, makes it a criminal offence for the directors of an organisation to mislead auditors (ICAEW 2005), which is what happened in the case of Enron, where chief executives defrauded the company by falsifying Enron's publicly reported financial results and also made false and misleading public representations concerning Enron's business performance and financial condition (SEC 2004).

Furthermore all company CEOs and the chief financial officer (CFO) of any Security Exchange Commission (SEC) registered company have to sign the certification on all quarterly as well as annual reports. Section 404(a) requires the issuer of financial statements to include internal control statements in their annual reports, while section 404(b) requires an auditor to confirm and report on any management assessments made under section 404(a) as part of the audit (ICAEW 2005).

From the above, it is clear that section 404 of the Sarbanes-Oxley Act of 2002 attempts to enforce more transparency and accountability from the people entrusted with the management of stakeholders’ funds and the primary aim is to rebuild investors’ confidence in corporate reports by protecting them from management’s self-opportunism. The American corporate governance system has been characterised by corporate scandals in the past and it seems that the relevant officials will never be able to put the correct measures into place to avoid the recurrence of these scandals. They merely react after the company has collapsed, at the stage when corrupt management officials have already misused what they should be safeguarding.

2.3.4 South Africa

2.3.4.1 Short historical review

Early accounts of corporate governance in South Africa can be traced back as early as 1652. In 1652, Jan van Riebeeck, on behalf of Dutch East India Company (DEIC), established the Cape of Good Hope. The laws governing companies at that time was known as Roman-Dutch law (Thompson 2001). In 1795, Great Britain took control of the Cape of Good Hope. Thompson (2001) argues that the main aim of taking control of the Cape of Good Hope was to prevent France from taking over, but also to make the Cape a stopover for ships travelling to Australia and India. However, after a few years, Great Britain returned the Cape of Good Hope to the Dutch until the bankruptcy of the DEIC.

Shortly after the bankruptcy of the DEIC, Thompson (2001) states that Great Britain again seized the Cape of Good Hope in 1876. The British Government introduced English law, also known as common and statutory law, in the 19th century. The discovery of diamonds in 1867 and gold in 1884 encouraged economic growth and immigration to South Africa (Thompson 2001).

According to Jones (2003), the above discoveries (diamonds and gold) attracted people from all over the world and turned Kimberley into a town of 50,000 people within five years. Jones (2003) states that as the mines became deeper, they became more difficult to work on, and for this reason a number of businessmen consolidated themselves into larger mines. An example of this is Cecil Rhodes, who gained control over most of the mines through the De Beers Consolidated Company during this period.

In 1886, a second major mineral was found in Witwatersrand. This is a period when the world's largest deposit of gold-bearing ore was discovered. Jones (2003) notes that even though these goldfields were not as rich as gold deposits found in Canada and Australia, their consistency made them specially well-suited to industrial mining methods. Because of the political power of mining companies, the Cape Colony took over mining districts such as Kimberley and Cecil Rhodes was elected prime minister of the Cape Colony. English law governed these colonies and for this reason, corporate governance was based on this law (Jones 2003).

The *South African Company Law for the 21st Century: Guidelines for Corporate Law Reform* (RSA 2004b) concurs with the above history given by Jones (2003) and Thompson (2001), by stating that company law has existed in South Africa since 1861, beginning with the Joint Stock Companies Limited Liabilities Act No 23 of 1861 of the Cape Colony. This Act, along with other provincial company legislation, was a carbon copy of the equivalent English legislation. The first national company law was introduced in 1926 with the Union Companies Act, which was amended from time to time along the lines of the latest English legislation. The 1926 Act was replaced in 1973 by the Companies Act No 61 of 1973, which, despite efforts to innovate and develop a direction more appropriate for South Africa, remains much in the mould of English law (RSA 2004).

Naidoo (2002: 10) also confirms the above by stating that before corporate governance was institutionalised in South Africa its requirements were based on the Companies Act, 61 of 1973 as well as common law. Naidoo (2002: 11) further states that common law prescribed certain requirements for the directors and officers of a company. Naidoo (2002) defines common law as “a law which is not legislated in the statutes books of a country, but which nevertheless over time and through wide acceptance gains the force of a law”. The general body of South African company law draws extensively from English legal precedent (Naidoo 2002).

Malherbe and Seagal (2001) view the history of South Africa's corporate governance as based on the political climate. According to Malherbe and Seagal (2001), South Africa was isolated from the world's economy by the countries of the world, in order to put political pressure on the government of that period, so that it would recognise human rights. The government of the National Party had imposed apartheid (apartheid is derived from the Afrikaans word for apartness) in South Africa. According to the African Encyclopedia (2008), apartheid differentiated between four groups of people, namely Bantu (black Africans), Whites, Coloureds (of mixed race) and Asians (Indians and Pakistanis). Black Africans had limited access to everything, for example, their education was inferior and they were not allowed to stay in urban areas.

Countries of the world viewed apartheid as a human rights violation and they denounced it. They (countries of the world) mobilised themselves and in 1961, South Africa was forced to withdraw from the British Commonwealth by member states that were critical of the apartheid system. In 1985 the governments of the United States and Great Britain imposed selective economic sanctions on South Africa in protest of its racial policy (African Encyclopedia 2008).

From the discussion by Malherbe and Seagal (2001) as well as the African Encyclopedia (2008), it is clear that domestic firms could not access foreign capital markets. This political isolation caused South African firms to be left behind in the best corporate governance practices, reforms, laws and regulations. The change in the political climate in the 1990s which led to political reform also meant that South Africa was readmitted to the international arena.

The new government's goal was to increase economic growth in order to fund social services and create employment. The new government viewed corporate governance reforms as an imperative in order to attract foreign investors. Many stakeholders, such as regulatory agencies, the accounting profession and the Johannesburg Securities Exchange were encouraged to apply international standards in South Africa so that they could serve the international community (Malherbe & Seagal 2001).

South Africa's Minister of Finance, Mr. Trevor Manuel said the following in his address to the Institute of Chartered Secretaries and Administrator (ICSA): "Corporate Governance is not just a passing fad; it is an unequivocal, unavoidable necessity'' (ICSA 1999). This statement confirms the new government's commitment to good corporate governance practices in South Africa.

From this overview, it appears that the history of South Africa's corporate governance has been politically motivated, for instance, from the time of the DEIC and De Beers Consolidated Company, to the isolation of South African firms by the international community in protest of apartheid, which caused the country to be left behind, the political reforms that led to the readmission of South Africa to the international arena, right through to the return of investors to the South African market after the change in political climate in the country.

2.3.4.2 Recent corporate governance reforms in South Africa

Corporate governance in South Africa was institutionalised by the publication of the King I (IOD 1994) report on corporate governance in November 1994. The King committee on corporate governance was formed in 1992 to improve the state of corporate governance in South Africa. The report went beyond the financial and regulatory aspects of corporate governance by advocating an integrated approach to good governance in the interests of a wide range of stakeholders and showing regard for the fundamental principles of good financial, social, ethical and environmental practice (IOD 1994).

The King II report (IOD 2002) was released in 2002. The King code (as it is known) encourages openness and accountability for those who are entrusted with shareholders' funds (IOD 2002). Some of the new legislation for social and political transformation has also coincided with the recommendations made by the King committee. Significant examples include the Labour Relations Act, 1995 (RSA 1995), the Basic Conditions of Employment Act, 1997 (RSA 1997), the Employment Equity Act, 1998 (RSA 1998a) and

the National Environmental Management Act, 1998 (RSA 1998b) and a number of others (Naidoo 2002 & IOD 2002).

A further important aspect of recent reforms in South Africa's corporate governance was the revision of the listings requirements by the JSE. These revisions require companies to disclose minimum corporate governance statements in their annual reports. Other legislative developments since the publication of the King I report (IOD 1994) include the introduction of the Insider Trading Act, 1998 (RSA 1998c), which provides for more rigorous supervision and monitoring of insider trading, the Public Finance Management Act, 1999 (RSA 1999) which brings into force more stringent provisions for reporting and accountability by adopting an approach to financial management in government that focuses on outputs and responsibilities rather than the rule-driven approach under previous legislation. Finally there has been a comprehensive update of the provisions and regulations governing the Banks Act, 1990 (RSA 1990), which substantially enforces higher levels of corporate governance compliance and risk reporting in banking institutions (Naidoo 2002 & IOD 2002).

Recent corporate governance reforms in South Africa were reflected when the South African government passed the Corporate Laws Amendment Act, 2006 (RSA 2006) which captures the most important changes to the Companies Amendment Act, 2004 (RSA 2004a), which consist of amendments of the Company's Act, 1973 as amended (RSA 1973). The Corporate Laws Amendment Act, 2006 (RSA 2006) incorporates the recommendations made by the King II report (IOD 2002) thereby legalising corporate governance in South Africa.

Further to the above corporate governance reforms, the King II report (IOD 2002) is set to be revised. The Corporate Laws Amendment Act, 2006 (RSA 2006) is now effective and the Companies Bill, (RSA 2007) that is set to replace all the Corporate Laws in South Africa is currently being discussed. The details of the Corporate Laws Amendment Act, 2006 (RSA 2006), the Companies Bill, 2007 (RSA 2007) and the revision of the King II report (IOD 2002) are discussed in Chapter 3.

2.4 COMPARING PAST AND PRESENT CORPORATE GOVERNANCE PRACTICES IN GERMANY, THE UK, THE US AND SOUTH AFRICA

2.4.1 Comparing past corporate governance practices

As early as 1884, Germany had a Company's Act which protected small shareholders and the general public from exploitation by the managers and supervisors of companies. The German Company's Act required full disclosure of information from all companies. The most important feature of Germany's past corporate governance is that companies did not have board members, but instead of boards of directors they had supervisors who sat on supervisory boards.

While Germany had strict corporate laws, the UK economy consisted mainly of pyramid firms. These kinds of firms (pyramid firms) gained importance in the 20th century, and their proponents argued that setting these firms was a defence against hostile takeovers. Pyramid firms were owned by wealthy families and were permitted to practice insider trading. Investors lobbied for these firms to be dissolved as they felt that they were not promoting good governance. In the US the development of corporate governance was stimulated by the 1929 Wall Street Crash, the 1929 to 1932 period of the Great Depression and World War II. The US experienced the emergence of multinational corporations more than any country after World War II. This led to the establishment of the managerial class. Corporations started to hire experienced corporate managers to run their business affairs as early as the 1930s.

In South Africa, company law has existed since 1861, beginning with the Joint Stock Companies Limited Liabilities Act No 23 of 1861 of the Cape Colony, which, along with other provincial company legislation, was a carbon copy of the equivalent English legislation, since South Africa was a British colony. The first national company law was introduced in 1926 with the Union Companies Act, which was amended from time to time along the lines of the latest English legislation. The 1926 Act was replaced in 1973

by the Companies Act No 61 of 1973. The Company's Act of 1973 became South Africa's corporate governance reference before the King I report.

2.4.2 Comparing the present corporate governance practices

In Germany authorities updated their corporate governance laws by instituting the government commission on corporate governance in 2001. The Government Commission on Germany Corporate Governance passed the code in 2006. This code came to be known as the German Corporate Governance Code. This code is mandatory and it requires all companies to comply with its requirements. If a company cannot comply with the requirements of the code, it should explain why it cannot comply with the code.

Recent corporate governance developments in the UK are based on the Cadbury report of 1992, the Greenbury Report of 1995, the Hampel Report of 1998, the Turnbull Report of 1999 and the Higgs Review of 2003. These corporate governance reports recommended the self-regulation approach, whereby reporting of compliance with corporate governance is part of the listing requirements for public companies. These reports further emphasise the board as a focal decision point, the emphasis being on appropriately constituted board sub-committees (remuneration, audit and nomination), independent non-executive directors and the separation of chairman and chief executive positions.

In the US, the demise of big companies such as WorldCom and Enron Corporation reflected a need to reform US corporate governance. The demise of these companies and others led to an erosion of confidence in corporate reports. The American Congress responded to these corporate governance problems by passing the Sarbanes-Oxley Act of 2002. The New York Stock Exchange (NYSE) adopted the Sarbanes-Oxley Act and required all listed companies to comply with it. The adoption of the Sarbanes-Oxley Act of 2002 reformed the US Companies Act.

In South Africa, the publication of the King I and the King II reports on corporate governance enhanced corporate governance. Recent corporate governance reforms in South Africa were reflected when the South African government passed the Corporate Laws Amendment Act, 2006 (RSA 2006), which captures the most important changes to the Companies Amendment Act, 2004 (RSA 2004a), which amended the Company's Act, 1973 as amended (RSA 1973). Further to the above corporate governance reforms, the King II report (IOD 2002) is set to be revised in 2008. The Companies Bill of 2007 is set to replace all Corporate Laws in South Africa and is currently being discussed. These changes reflect the willingness of South African authorities to comply with international standards in order to protect investors.

2.5 SUMMARY AND CONCLUSIONS

The first part of this Chapter discussed agency theory, the agency problem, agency costs and corporate governance. In a discussion of agency theory of the firm, it appeared that the existence of the agency problem is a result of the owner's inability to run the company on a day-to-day basis. The hiring of managers to manage owners' affairs leads to the agency problem. It also appears that the costs associated with monitoring agents (known as agency costs) are exorbitant and are normally diverted to owners. Cost-effective monitoring devices consist of developments in accounting, financial reporting and the auditing of annual reports of a company. This is done to impose a duty of accountability and transparency upon the managers of a company.

The second part of this Chapter dealt with the historical development and current practices regarding corporate governance in Germany, the UK, the US and South Africa. As mentioned earlier, these overseas countries were preferred because they are three major trading partners of South Africa. The discussion of historical development established that the evolution of corporate governance in all these countries was based on events such as the 1929 Wall Street Crash in the US, changes in the political environment in South Africa, the need to dissolve pyramid firms in the UK, and in Germany, corporate

governance was promoted by efforts to improve the European single market for financial services and products.

Recent corporate governance practices have been spearheaded by the need to promote higher standards of ethical conduct in companies and a range of legislation that promotes accountability and transparency in the use of shareholders' capital. The current corporate governance reforms in the world are mainly attributed to the collapse of WorldCom and Enron, the giant communication and energy companies, respectively in the US, and these collapses highlighted the risk of concentrating power and decision making in the hands of a few individuals in companies (CEOs in this case). Based on the above, there is now a general consensus around the world that there needs to be balanced power in companies. Chapter 3 of this study discusses corporate governance in South Africa's listed companies.

CHAPTER 3

CORPORATE GOVERNANCE IN SOUTH AFRICA

3.1 INTRODUCTION

Corporate governance in South Africa was given new wind by the publication of the King I report (IOD 1994) on corporate governance in 1994. Although the 1994 King I report (IOD 1994) focussed a huge amount of interest onto South Africa's corporate governance, it does not mean that corporate governance did not exist in South Africa before 1994. As indicated in Chapter 2, corporate governance in South Africa was based on the Companies Act, 1973 (RSA 1973) as well as common law. The publication of the 1994 King I report (IOD 1994) on corporate governance went beyond the requirements of the Companies Act, 1973 (RSA 1973). The King I report (IOD 1994) recommended more disclosure in the annual reports of companies, thus incorporating international best corporate governance practices.

Within 13 years of the publication of the King I report (IOD 1994), corporate governance in South Africa had changed drastically from consisting mainly of ethical issues to becoming an important factor in the success and revival of the country's capital markets and, in due course, the growth prospects of the corporate economy. While corporate governance has played such an integral part, recent surveys undertaken to monitor companies' compliance with the requirements have indicated that problems exist within the framework. An example is the KPMG report (KPMG 2006) on sustainable development which reported that "many JSE listed companies are developing King II checklists and ticking off compliance without necessarily buying into the spirit of good corporate governance" (KPMG 2006).

Referring to “ticking-off” compliance by companies who do not buy into the spirit of good corporate governance, King (2006: 12) asks, “Can it be good governance to comply mindlessly with the guidelines in a code or the provisions of a statute?” For King (2006), a compliance officer who reports to a board that a company has complied with the codes or the rules of governance in the country in which it is registered, without the board applying its mind to how the company should be governed, represents poor governance. King (2006) argues that a “comply or explain” approach is more sensible than a “comply or else” regime, however, even within the “comply or explain” regime one finds mindless compliance to avoid having to go through the mental exercise of explaining non-compliance.

Based on the above introduction, this Chapter intends to place South Africa’s corporate governance in perspective by discussing the behaviour which directors and company officials imitate when committing corporate sins and by discussing the impact of corporate governance on reporting. In an attempt to cover the whole corporate governance framework and recent reforms, the discussion on corporate sins and reporting is followed by a discussion of the incorporation of the King II report (IOD 2002) in the Company’s Amendment Act, 2004 (RSA 2004a), Corporate Laws Amendment Act, 2006 (RSA 2006) as well as the impact of the Johannesburg Securities Exchange listings requirements for corporate governance.

3.2 CORPORATE SINS

IOD (2002) defines a corporate sin as an intentional violation of the company’s set of laws. Directors and managers have first hand information regarding the affairs of a company as they run day-to-day activities. As a result of their exposure to these affairs, directors and managers may be tempted to perform activities and take actions that are not in the best interest of shareholders, thus not to the benefit of the principal, thereby committing corporate sins.

Sluggishness, greed and fear are identified as the three corporate sins most committed by those entrusted by stakeholders to safeguard their interests (company directors and managers) (IOD 2002). The following is the detailed explanation of the corporate sins mentioned above:

- Sluggishness is a loss of interest by the director when the corporation gives way to administration, meaning that company directors are well aware of the company rules but are very slow to adopt them thus continuing to transgress company rules.
- Greed is explained as a decision taken by the directors of a company which is not in line with company policies, and as a result, the decision taken benefits the directors rather than benefiting the company as a whole, in other words there is no goal congruence.
- Fear is explained as a situation where directors become too submissive to a certain class of stakeholders and ignore critical issues regarding the survival of the company (IOD 2002).

Any manager who acts in the way described above, abuses his/her power and is not acting in the best interest of the company, thus committing corporate sins. To counteract corporate sins, Emery *et al* (2004) suggest that company directors must be people of integrity, people who are highly capable of efficiently running a company, and they also need to have a good management track record. They further suggest that the penalties for performance failure or the rewards for reaching desired results must be clearly outlined so as to reduce self-opportunism by those who are entrusted with safeguarding stakeholders' funds. This will enforce the spirit of transparency and accountability within an organisation (Emery *et al* 2004).

According to Emery *et al* (2004: 380), promoting good governance is not only when the directors and managers of a company own the entire company and are committed to efficiently running the company to protect their own capital. Good governance is when directors are generally free to apply and protect corporate assets as their own private property (Emery *et al* 2004).

Corporate governance provides a platform by means of which the corporate sins of company officials can be reduced. The above discussion emphasises the basic concern of corporate governance, which is to promote the means by which company directors and officials are held accountable to capital providers (stakeholders) for the use of company's assets without sluggishness, greed, fear and negligence and to ensure that stakeholders remain informed about company affairs.

3.3 REPORTING AND CORPORATE GOVERNANCE

The objective of financial statements is to provide information on the financial position, performance and changes in financial position of an enterprise. The information contained in these reports has to be useful to a wide range of users in their economic decision-making. The International Accounting Standards Board (IASB) (2007: 26 the framework paras. 12 & 13) notes that financial statements consisting of the statement of financial position, statement of comprehensive income, statement of cash flow, statement of changes in equity, directors' report, auditors' report and notes to the financial statements generally meet the needs of the users. However, the information relating to the disclosure of integrated sustainability reports, amongst others, for example, has become of much importance to a wide range of users and should be reported in the annual report of a company.

The objective of corporate governance reporting in South Africa is based on the principles of fair treatment of shareholders in a company, full disclosure of corporate governance statements in annual reports, the provision of reliable and timely disclosure of information concerning corporate performance and ownership, and the holding of annual general meetings of shareholders (IOD 2002).

In South Africa, maximising the value of the owners' investment is considered the primary corporate objective (IOD 2002). According to Naidoo (2002: 10), before 1994 corporate governance requirements for companies registered in South Africa were based on the Companies Act, 61of 1973 (RSA 1973) as well as common law.

In line with world trends and the demand for non-financial information by investors, corporate governance reporting became one of the critical components of annual reports. The King committee on corporate governance was established to address reporting on corporate governance in South Africa. The publication of the King I report (IOD 1994) institutionalised corporate governance. However, at that time, the report on corporate governance was only a recommendation.

The publication of the King I report (IOD 1994) on corporate governance in November 1994 was a deliberate step towards improving the state of corporate governance in South Africa. This report went beyond the financial and regulatory aspects of corporate governance in advocating an integrated approach to good governance in the interests of a wide range of stakeholders and having regard for the fundamental principles of good financial, social, ethical and environmental practice (IOD 1994).

The King I report (IOD 1994) was hailed internationally as a seminal work on corporate governance. From the above, it is clear that the King I report (IOD 1994) was published long before the governance meltdowns at Enron and WorldCom in 2002. The publication of the King II report (IOD 2002) based its context on these international failures, as well as the corporate governance problems which led to the demise of South African companies such as Leisure-net, Regal Bank, and the Retail Apparel Group (Naidoo 2002).

The evolving global economic environment and recent legislative developments such as the Black Economic Empowerment Act, 2003 (RSA 2003), Labour Relations Act (LRA) (No. 66 of 1995), Basic Conditions of Employment Act (BCEA) (No. 75 of 1997 and other legislation, necessitated updating the King I report (IOD 1994). The King committee on corporate governance developed the King II report (IOD 2002) on corporate governance in South Africa. The King II report (IOD 2002) encourages openness and accountability from those who are entrusted with the shareholders' funds (IOD 2002).

The King II report (IOD 2002) acknowledges the need for moving away from the single bottom line, that is, shareholders' profit, to a triple bottom line, which embraces the economic, environmental and social aspects of a company's activities. The King II report (IOD 2002) further requires that minimum corporate governance statements be disclosed in the annual reports of companies; however, there is room for voluntary disclosure by companies beyond those recommended by the report (IOD 2002). The King II report (IOD 2002) on corporate governance further introduces the concept "good governance" in the South African corporate landscape by identifying the following seven characteristics:

- Discipline — the undertaking by senior management to adhere to universally accepted and recognised principles of good governance.
- Transparency — the disclosure of company information that is useful to stakeholders to allow them to make the informed decisions.
- Independence — the company needs to appoint the external auditors who are independent of directors and managers of the company.
- Accountability — individuals who make decisions regarding the affairs of the organisation must be accountable for their actions. The King II report (IOD 2002) calls for effective mechanisms to ensure such accountability.
- Responsibility — management is responsible to the board of directors and the board is responsible to the stakeholders of the company.
- Fairness — the rights of various groups represented in an organisation need to be respected at all times.
- Social responsibility — the company must be able to respond to social issues. A good corporate citizen need not exploit the environment in which it operates nor exploit human rights (IOD 2002).

Non-adherence to corporate governance principles has led to many corporate failures in the past. This resulted in stakeholders questioning the usefulness of corporate governance statements disclosed in the annual reports of companies. Even though directors strive to follow the above principles, they do not always succeed because financial aspects such as earnings per share, dividends declared, economic value added, market value added and cash flow returns on investments take preference over non-financial issues in today's business environment (IOD 2002).

In his book *The Corporate Citizen,* King (2006: 123) affirms that "the key challenge facing the global company today is to ensure that quality governance principles are applied by the local boards of its many subsidiaries. The principles are those of fairness, accountability, responsibility and transparency, based on a foundation of intellectual honesty" (King 2006).

Corporate governance statements disclosed in the annual reports of companies should reflect the true state of affairs of the company in a particular period and directors of the company should commit themselves in the directors' report to the accuracy of information contained therein. Further to the above, the IASB (IASB 2007: the framework paras. 25, 26 & 31) states that financial information and the overall information provided in the annual reports of a company has to meet certain characteristics. These characteristics are that:

- Information disclosed in annual reports should be easy to understand.
- Information disclosed must be generally accepted and free of any bias or manipulation.
- Information has to be relevant and must be published in time for use by decision-makers.
- Information must be reliable (free of error) and easily accessible to users (IASB 2007: the framework paras. 25, 26 & 31).

The objective of reporting is to promote transparency and accountability (IOD 2002) by providing information that satisfies the needs of a diverse set of users such as shareholders, investors and security analysts, managers, employees, lenders and other suppliers, customers, and government regulatory agencies.

The IASB (2007: the framework paras. 33 & 34) states that directors and managers of a company act in good faith and honesty if they provide users (as listed above) of annual reports with information that fairly presents the state of affairs of a company and information that allows users to make sound decisions based on this information. Based on the above discussion, it is clear that these requirements are equally relevant to corporate governance disclosures.

3.4 THE KING REPORTS AND COMPANY LAW REFORMS

In 2003, a broad legislative reform programme was initiated by the Department of Trade and Industry (DTI). The reform programme included a review of existing securities regulations as well as corporate structures and practices in the area of corporate governance. In 2004, a policy document entitled '*South African Company Law for the 21st Century: Guidelines for Corporate Law Reform*' on corporate law reform was published (RSA 2004b).

The above policy paper set out the basis for a redraft of the South African Companies Act, 1973 (RSA 1973). The overall aim was to align the Companies Act, 1973 (RSA 1973) with 21st century thinking and practice, in that way ensure a regulatory framework that promotes growth, innovation, stability, good governance, confidence and international competitiveness (RSA 2004b).

Fundamental legal developments have taken place in South Africa since 1973. The most notable factors that contributed to the changes included amongst others, the adoption of the new constitution in 1996 that incorporates a Bill of Rights, the King II report (IOD 2002) on corporate governance, the failures of large corporations such as Enron and WorldCom and the Sarbanes Oxley Act, 2002 in the US (RSA 2004b).

As mentioned above, the main objective of the Corporate Laws Amendment Act, 2006 (RSA 2006) was to repeal the Companies Act 61, 1973 (RSA 1973) and introduce a new core of company legislation that would be in line with international best practice. The Act inserts new definitions, which distinguish between widely held companies and limited-interest companies; it limits the liability of various office bearers to liabilities arising from gross negligence in relation to the performance of their functions (RSA 2006).

The Corporate Laws Amendment Act, 2006 (RSA 2006) also broadens the Minister of Trade and Industry’s powers of delegation, provides for new ways of giving notice, makes further provisions regarding financial assistance for the purchase of a company's shares, eliminates certain formalities regarding memoranda and articles, allows the registrar of companies to restore the registration of a company which has been deregistered in certain circumstances and makes further provisions regarding matters to be stated in a prospectus (RSA 2006).

In addition to the above, the Corporate Laws Amendment Act, 2006 (RSA 2006) changes requirements relating to the disposal of the undertakings of a company, makes new provisions in respect of the disclosure of information, makes new provisions for the appointment of auditors and audit committees, provides a new perspective in respect of financial statements, makes new provisions regarding the Securities Regulation Panel, makes provisions in respect of financial reporting standards, establishes and makes further provisions for a Financial Reporting Standards Council and a Financial Reporting Investigations Panel and creates an offence in respect of non-compliant financial reports (RSA 2006).

A discussion on the changes as well as the impact of these changes on corporate governance follows below.

3.4.1 Distinctions between companies

The Company's Act, 1973 (RSA 1973: sec. 1) distinguished between private companies and public companies. The Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 1h) distinguishes between limited-interest companies and widely held companies. According to Section 1h of the Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 1h), a distinction between a widely held and a limited-interest company is made as follows:

- A company is a widely held company if:
  - its articles provide for an unrestricted transfer of its shares (RSA 2006: sec. 1 (6) (a) (i));
  - it is permitted by its articles to offer shares to the public (RSA 2006: sec. 1 (6) (a) (ii));
  - it decides by a special resolution to be a widely held company (RSA 2006: sec. 1 (6) (a) (iii)); or
  - it is a subsidiary of a company described above (RSA 2006: sec. 1 (6) (a) (iv)).

- A company with two or more types or classes of shares is a widely held company if its articles provide for the unrestricted transfer of shares (RSA 2006: sec. 1 (6) (b)).

- A company is a limited-interest company if it is not a widely held company (RSA 2006: sec. 1 (6) (d)).

In the case of a widely held company an offer of its shares to the public is permitted and the transfer of its shares is unrestricted. All companies that are not widely held companies are deemed to be closely-held companies. Widely held companies, not-for-profit companies and certain closely-held companies, for example, those which contribute to public health, may be categorised as public-interest companies. Public-interest companies are subject to more extensive accounting, disclosure and transparency requirements. (RSA 2006: sec. 1).

Companies which are able to offer their shares for sale to the public (including, but not limited to, publicly-listed companies) will now be obliged to appoint audit committees. An audit committee must consist of at least two members, both of whom must be independent non-executive directors (RSA 2006: sec. 24 (3) (sec. 269A (3) & (4))). The functions of the audit committee include the duty to nominate an auditor for appointment by the board, to fix the terms of the auditor's engagement and to determine which non-audit services the auditor may provide to the company. The audit committee is also required to receive and deal appropriately with any complaints either to the accounting practices and internal audit of the company or the content of auditing of its financial statements (RSA 2006: sec. 26 (sec. 270A (1))).

Where a firm of auditors is appointed as a public company's auditor, the appointment must specify the name of the individual who will actually undertake the audit. The auditor must be independent of the company (RSA 2006: sec. 26 and sec. 29 (sec. 274 (1)) & sec. 270A (5)). Furthermore, the same individual will not be permitted to serve as such for more than five consecutive financial years. Where he/she has served as the auditor for two or more financial years and then ceases to be the auditor, that individual may not be appointed as the auditor again until at least a further two financial years have elapsed (RSA 2006: sec. 30 (sec. 274 (1) & (2))).

Section 45 of the Corporate Laws Amendment Act, 2006 (RSA 2006: sec 45 (sec. 300A (1)) requires the designated auditor to meet with the audit committee of a widely held company not more than one month before the board meets to approve the financial statements of a company for any financial year, so as to consider matters which appear to the auditor or the audit committee to be of importance and relevant to the proposed financial statements and to the affairs of the company generally (RSA 2006: sec 45 (sec. 300A (1)).

The auditor will also be required to attend every annual general meeting of the company where his/her financial statements are presented in order to answer questions concerning the audit of such financial statements. This Act has a material impact on the accounting profession. One of the most far-reaching effects is that the auditors of public companies will be prohibited from providing the same company that they are auditing with bookkeeping or accounting services and, other non-audit services that would be subject to its own auditing, internal audit or tax advisory services while acting as that company's auditor or services which the audit committee of a company may deem to prejudice the auditors independence (RSA 2006: sec. 26 & sec. 32 (sec. 275 A (1) & (2) & sec. 270A (5))).

Based on the above, it is clear that widely held companies will have more extensive corporate governance requirements than the other forms of companies captured in the Corporate Laws Amendment Act, 2006 (RSA 2006), that is, they will be subject to more extensive requirements relating to audit committees and auditors.

3.4.2 Financial assistance for the purchase of a company's own assets

The significant changes in the Corporate Laws Amendment Act, 2006 (RSA 2006) in relation to the Company's Act, 1973 (RSA 1973) include the following: firstly, the Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 9 (sec. 38 (1) (a) & (b))) substantially increases the circumstances in which a company may provide financial assistance for the purchase of its own shares; secondly, it confers greater protection to

minority shareholders in the face of take-overs (RSA 2006: sec. 21 (sec. 228)); thirdly, it imposes new obligations on companies and auditors in order to promote the independence of these auditors (RSA 2006: sec. 26 (sec. 270A (5))); and in the fourth place, it gives legal backing to the accounting standards currently used for financial reporting (RSA 2006: sec. 36 (sec. 285A)).

Some of the corporate governance recommendations made by the King II report (IOD 2002) which were not previously legalised have now been legalised by the Corporate Laws Amendment Act, 2006 (RSA 2006). An example of this includes Section 38, dealing with the prohibition of financial assistance to purchase shares of a company or holding company.

In the past, section 38 of the Companies Act, 1973 (RSA 1973: sec. 38) severely restricted a company from providing financial assistance for the purchase of its own shares or the shares of its holding company. The amendments to section 38 have removed these restrictions by permitting a company to give financial assistance for the purchase of its own shares where the board of directors (the board) is satisfied that the company will remain liquid after the transaction concerned has taken place, that liquidity requirements are met subsequent to the transaction and for its duration, the company will be able to pay its debt and when the terms upon which the assistance is to be given have been authorised by a special resolution of its shareholders (RSA 2006: sec. 9 (sec. 38 (2A) (1) (a) (i) & (ii)).

In assessing the solvency of the company (the solvency test), it is important that the board is satisfied that, on a fair valuation, the consolidated assets of the company will exceed its consolidated liabilities after the transaction to avoid insolvency. For this purpose the board must take into account any contingent liabilities and be sure that the company will be able to pay its debts as they become due in the ordinary course of the business (RSA 2006: sec. 9 (sec. 38 (2B)).

The solvency test is more or less the same as the one adopted in 1999 when section 85 of the Companies Act, 1973 (RSA 1973: sec. 38) was amended to permit a company to buy back its own shares. Although the advisory memorandum to the Corporate Laws Amendment Act, 2006 (RSA 2006: sec 9 (sec. 38)) states that the amendment to section 38 of the Companies Act, 1973 (RSA 1973: sec. 38) is intended to facilitate Black Economic Empowerment (BEE) transactions, the amendments themselves do not mention BEE at all. As a result of the above, the amendments of section 38 are not restricted to BEE transactions alone, and should thus facilitate most financial assistance transactions which meet the solvency test (RSA 2006: sec 9 (sec. 38 (2A) (1) (a) (i) (ii) & (b))).

From the above, it is apparent that the Corporate Laws Amendment Act, 2006 has enhanced governance. The Act now provides that the prohibition set out in section 38 will no longer apply and that a company may therefore provide financial assistance for the acquisition of its own shares provided that:

- Firstly, the company's board of directors is satisfied that subsequent to the transaction, the consolidated assets of the company, fairly valued, will be more than its consolidated liabilities (the solvency test), that subsequent to providing the assistance, and for the duration of the transaction, the company will be able to pay its debts as they become due in the ordinary course of business (liquidity test); and
- Secondly, the terms upon which the assistance is to be given is sanctioned by a special resolution of its members.

Further to the above, the amendment favours the solvency and liquidity tests over the preservation of capital and will be particularly useful in the structuring of BEE deals. In most cases, potential BEE partners need finances to purchase company shares. If they are not financed internally, they resort to financial institutions which may be reluctant to provide financing without sufficient security. With the Corporate Laws Amendment Act, 2006 (RSA 2006), companies will be able to fund share purchases with simpler structures and at lower interest rates, subject to compliance with section 38 of the Act.

3.4.3 Disposal of the undertaking or the greater part of its assets

Another significant change includes section 228, dealing with the disposal of the undertaking or the greater part of its assets. The Companies Act, 1973 (RSA 1973: sec. 228) previously contained a number of mechanisms which could be used to forcibly acquire the shares of minority shareholders in the event of, for example, a takeover bid or the acquisition of a publicly-listed company. It also contained provisions which protected the interests of minority shareholders in such instances. (RSA 2006: sec. 21 (sec. 228)).

The main reason for the above is that section 228 in terms of the Companies Act, 1973 (RSA 1973) allows a company to dispose of the whole or the greater part of its assets, or the whole or substantially the whole of its undertakings, if the disposal is endorsed by an ordinary resolution of its shareholders. A simple majority is achieved if a quorum is present at the shareholders' meeting convened to consider the ordinary resolution and 50,1% of the shareholders who are present or represented and who vote at the meeting, vote in favour of the resolution (RSA 1973: sec. 193 & 195).

Further to the above, The Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 21 (sec. 228 (2))) has amended section 228 so as to require shareholders to approve the disposal of the whole or the greater part of the assets of the company by way of a special resolution. In order to be passed, a special resolution requires that 75% of shareholders, who are present or represented by proxy and who are voting at the meeting, vote in favour of such resolution. The minimum quorum requirement for a meeting convened to consider a special resolution is shareholders who do not hold less than 25% of the total votes of all shareholders and who are entitled to attend and to vote at the meeting (RSA 1973: sec. 199).

A disposal requiring shareholders approval as described above will constitute an affected transaction under section 440A (1) of the Companies Act (RSA 1973: 440A (1)) if the selling company or its holding company fall within the ambit of the Securities Regulation Code on takeovers and mergers. It is possible that the Securities Regulation Panel may

direct that any shareholder whose vote may result in a direct or indirect conflict of interest, resulting in an inequity to any other shareholder, may not vote at a general meeting. This will mean that the majority of shareholders may not be able to force through a special resolution that is aimed to suit their own interests against the wishes of the minority shareholders. (RSA 2006: sec. 21 (sec. 228)).

Another change to section 228 proposes that a special resolution will also be required where a disposal by a subsidiary would amount to a disposal by its holding company, based on the consolidated financial statements of that holding company. This amendment will bring both disposals of subsidiaries and disposals by subsidiaries within the scope of section 228, consequently also increasing the protection of minority shareholders (RSA 2006: sec. 21 (sec. 228 (2))).

It is important to note that the above provisions do not apply to a disposal between a wholly-owned subsidiary and its holding company or between two wholly-owned subsidiaries of the same holding company. (RSA 2006: sec. 21 (sec. 228 (5))).

What is evident from the above amendment of section 228 of the Companies Act, 1973 (RSA 1973: sec. 228) is that directors now require a decision to dispose of the whole or the greater part of the undertaking of the company or its assets. According to the Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 21), this decision will be made by a special resolution, that is 75% of shareholders with voting rights present at the general meeting. Previously, section 228 of the Companies Act, 1973 (RSA 1973) required the ordinary resolution.

Based on the above discussion, it is clear that shareholders of a holding company are now also required by section 21 of the Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 21) to take part in the disposal by a subsidiary, if the disposal amounts to the greater part of the assets or business of the holding company in relation to its consolidated financial statements. Even though section 21 of the Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 21) does not explicitly state this, it is apparent that both the

holding company and the subsidiary should pass special resolutions in this case, not only the holding company. It should be noted though that section 21 of Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 21) is silent on whether a third-party purchaser of the assets or business, who was not aware of the non-compliance with section 21 can enforce the sale agreement between parties. The section only states that the resolution will not be effective.

3.4.4 The Corporate Laws Amendment Act, 2006 with reference to certain sections of the Companies Bill, 2007 and corporate governance in South Africa

From the above comparisons of the amended sections, it is reasonable to state that the South African Companies Act, Companies Act, 1973 (RSA 1973), which has been in existence since 1973, was out of date and needed to be upgraded. The current Companies Amendment Act, 2004 (RSA 2004a) contains few issues relating to corporate governance, transparency, accountability, modern merger methods and minority shareholder protection. Some of these issues are captured and addressed in the new Corporate Laws Amendment Act, 2006 (RSA 2006), while more extensive coverage follows in a Companies Bill, 2007 (RSA 2007).

Although the Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 13 (sec. 63 (9) (1)) eliminate certain formalities regarding the memorandum and articles of a company, the Companies Bill, 2007 (RSA 2007) will simplify the incorporation of companies. Instead of the memorandum and articles of association which were previously used in the old Company's Act of 1973, a company's constitutional documents have been consolidated into one document namely the Memorandum of Incorporation. Further to the above, the Memorandum of Incorporation sets out the rights, duties and responsibilities of shareholders, directors and others stakeholders in relation to the company. (RSA 2007: sec. 15).

It is important to note that certain provisions of the Act may be distorted or limited in the memorandum or articles (memorandum of incorporation) of a company; however, there are specific unalterable provisions that apply, notwithstanding the provisions of the memorandum or articles. For example, section 228 (1) states that notwithstanding anything contained in its memorandum or articles, the directors of a company shall not have the power, save by a special resolution of its members, to dispose of:

- The whole or the greater part of the undertaking of the company; or
- The whole or the greater part of the assets of the company (RSA 2006: sec. 21 (sec.228 (1) (a) & (b))).

The above provisions ensure that certain protections built into the Corporate Laws Amendment Act (RSA 2006) will apply collectively.

The Corporate Laws Amendment Act, 2006 (RSA 2006) together with the Companies Bill, 2007 (RSA 2007) promotes and encourages transparency and high standards of corporate governance. Transparency is ensured through greater director accountability (RSA 2007: sec. 76) and the appropriate participation of all stakeholders.

3.4.4.1 Participation at shareholders' meetings

The Corporate Laws Amendment Act, 2006 (RSA 2006) further allows increased participation of shareholders at meetings, which is one of the areas where the Companies Act, 1973 (RSA 1973) has always been rigid. Section 45 of Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 45 (sec. 300A (2) & (3))) requires auditors of a widely held company to attend the annual general meeting, where the financial statement of a widely held company are considered and agreed upon. The Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 45 (sec. 300A (2) & (3))) further states that they (auditors of a widely held company) should respond to any question relevant to the audit of the financial statements.

3.4.4.2 Take-overs and mergers

With regards to take-overs and mergers, the Corporate Laws Amendment Act (RSA 2006) has retained the current methods of conducting take-overs and mergers. However, the processes in terms of the Companies Bill (RSA 2007) have been simplified. As an example of the above, Chapter 5 of the Companies Bill, 2007 (RSA 2007) on fundamental transactions, take-overs and offers introduce a new rule relating to mergers and amalgamations. This rule effectively allows two companies to merge to form one entity, subject to the satisfaction of the solvency and liquidity tests and certain approvals. (RSA 2007).

Even though the Companies Bill (2007) seeks to define legal offences under the Act, minority shareholders will in future be afforded better protection, in line with modern company law trends around the world. Further to the above, the Companies Bill, 2007 (RSA 2007: sec. 115 (2) (a) & (b)) allows a shareholder who does not wish to support a proposed merger or amalgamation to send an objection notice to the company. If the objection is not withdrawn, the shareholder may demand that the company pays to such shareholder the fair value for the shares if, amongst other things, the resolution for such action was supported by less than 75% of the shareholders entitled to vote. (RSA 2007: sec. 115 (2) (a) & (b)).

3.4.4.3 Shares without a nominal or par value

With regards to shares without a nominal or par value, it is important to note that there are no changes that were made in the Corporate Laws Amendment Act, 2006 (RSA 2006). The Companies Bill (RSA 2007: sec. 35 (2)) stipulates that shares will no longer have a nominal or par value. The board may issue authorised shares only for consideration or other benefit to the company. This means that the old and ineffective capital maintenance rule has been replaced by a regime based on solvency and liquidity. (RSA 2007: sec. 4).

3.4.4.4 Directors

The Corporate Laws Amendment Act, 2006 (RSA 2006: sec 24 (sec. 269A (4) (a) & (b)) provides that a director acts independently if he/she exercises his/her judgment impartially and he/she is not related to the company or its shareholders, customers, suppliers or other directors in a way that would lead a third party to conclude that his/her integrity, impartiality or objectivity is compromised by that relationship. A non-executive director is defined as "a director who is not involved in the day to day management of the company and has not been a full-time salaried employee of the company within the past three financial years and is not a member of the immediate family of the aforementioned" (RSA 2006: sec. 24 (sec. 269A (4) (a) & (b)).

Further on the above, standards on directors conduct are disclosed in detail in section 76 of the Companies Bill, 2007 (RSA 2007: sec. 76). Section 76 (3) (a) of the Companies Bill, 2007 (RSA 2007: sec. 76 (3) (a)) refers to the fact that directors must exercise powers and functions for a proper purpose; however, this is not explained in detail. The IOD (2008) believes that this phrase will continue to carry the common law connections attached to it through the developed jurisprudence.

3.4.4.5 Financial reporting standards and regulation

In order to prevent a company from selecting the method of accounting that best represents its financial position and financial performance and to harmonise the accounting practices of South African companies with those of the international community, the Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 36 (sec. 285A (1) (a))) has inserted a new section into the Companies Act which provides that financial statements of public companies must comply with financial reporting standards, i.e. International Financial Reporting Standards (IFRSs) and International Accounting Standards (IASs), these being statements of Generally Accepted Accounting Practice, which are issued by the Minister of Trade and Industry by publication in the Government Gazette from time to time on the advice of a newly established, fifteen member body called the Financial Reporting Standards Council (FRSC) (RSA 2006: sec. 36 (sec. 285A (1) (a) & sec. 440U))

The above-mentioned standards are more onerous than the current standards outlined in Schedule 4 of the Companies Act, 1973 (RSA 1973), but do not apply to companies which are not public companies. The FRSC will be responsible for establishing financial reporting standards for public companies, which are in line with the International Financial Reporting Standards of the International Accounting Standards Board (RSA 2006: sec 53 (1) (sec. 440P (1) & (2))).

In terms of the Companies Bill, 2007 (RSA 2007) it appears as if this function (FRSC) has been scaled down to being an advisory committee to the Minister, to advise the Minister on the regulations governing the form, content and maintenance of companies financial records and reports.

Another fifteen member body, called the Financial Reporting Investigations Panel, is also established. This panel is charged with the duty of investigating alleged non-compliance with financial reporting standards and recommends "appropriate measures for rectification or restitution". Its report may, "if it is in the interests of users", be published in the news media and must be made available for inspection by the public (RSA 2006: sec. 53 (sec. 440W (2))).

The above requirements have been omitted from the Companies Bill, 2007 (RSA 2007), instead, it is proposed that the commission will investigate compliance with accounting standards (RSA 2007: sec 169).

A public company and each of its directors or officers who is party to the issuing, circulation or publication of any financial statements which are materially incomplete or which do not otherwise comply with the above requirements will be guilty of an offence. The Act also makes it an offence for any person to be a party to the preparation, approval, publication, issuing or supply of a financial report that is false or misleading in a material respect, if such person knows or ought reasonably to suspect that it is false or misleading (RSA 2006: sec 39 (sec. 287A)). Based on the above, it is apparent that financial

reporting standards, i.e. the IFRSs and the IASs (generally accepted accounting practices) have been formally legalised by the Corporate Laws Amendment Act, 2006.

3.4.5 The anticipated King III report

Changes are also expected with regard to the King code. The Business Day (2007) recently reported that the King II report, which was published in 2002, will be updated during the course of 2008. According to the Business Day (2007), the updated report will be called the King III report. Dippenaar (2007) argues that even though the announcement of the King III report has been welcomed by investors, various directors questioned the need for an updated code of principles for good governance. According to Dippenaar (2007), directors argue that King II has already regulated corporate governance and that the code is achieving the objectives set out in the code itself.

The current corporate scandal involving the Fidentia Group (Business Report 2007b) indicates that despite the King II report (IOD 2002), which improved regulation of corporate governance, problems are still evident. The amendment of the Companies Act, 1973 (RSA 1973) by the Companies Amendment Act, 2004 (RSA 2004a) and further Amendment of the Companies Amendment Act (RSA 2004a) by the Corporate Laws Amendment Act, 2006 (RSA 2006) need further updating to strengthen the principles of corporate governance in South Africa.

The new Companies Amendment Act, 2004 (RSA 2004a) and Corporate Laws Amendment Act, 2006 (RSA 2006) incorporate some recommendations made in the King II report (IOD 2002). Any issues that have not been dealt with in the Companies Amendment Act (RSA 2004a) and Corporate Laws Amendment Act, 2006 (RSA 2006) should form the basis of updating the King II report (IOD 2002). Further issues in the King II report (IOD 2002) also require updating. These include, amongst other things, the requirements for compliance with the Black Economic Empowerment (BEE) (RSA 2003) code set out by the South African government and the influence of this BEE code on the composition of boards of directors in South African companies.

Another issue that should be addressed in the King III report is the election and the appointment of the board of directors. According to IOD (2002), the board of directors plays a crucial role in the enforcement of the corporate governance principles, however, Dippenaar (2007) argues that the King II report does not provide for adequate guidelines for the election and appointment of directors, whether executive or non-executive, therefore there is a need for clear rules as to how directors should be selected. The King III report has to clarify this aspect by providing the guidelines on the election and appointment of the board.

In addition to the above, King II (IOD 2002) requires a minimum number of non-executive directors on the board as well as on various board committees and sub-committees. It does not provide the guidelines on how these board and committee members should be nominated and elected in the board structure of a company and how these individuals should be appointed in the committees and subcommittees of the board of directors of a company. A further shortcoming of the King II report (IOD 2002) is that it gives no guidance on the maximum number of directorships that one person may hold at the same time.

The issue of guidelines on the election of the people to serve on the board of directors of a company has a number of impacts on the functioning of the company's board. For example, Dippenaar (2007) argues that most of them do not have the necessary skills and knowledge to operate at the level of board of directors. This could negatively affect management performance and the directions given by the board to management. In addition to the above, King II (IOD 2002) does not stipulate the age that a person should be in order to qualify as a director. The IOD (2008: 5) has already recommended that formal training and education of directors should form part of the qualification criteria to serve as a director.

Evidence of the above is contained in a report released by PricewaterhouseCoopers in January 2008. The report analysed issues such as board committees, director's independence, director's training and induction, cross-directorships (where directors hold both executive and non-executive positions) in several companies, and how the performance of non-executives should be measured. It also considered the question of how to broaden the pool of well-qualified independent and experienced directors, instead of traditionally electing them from the same group of retired CEOs and finance directors (PwC 2008).

According to the PwC report, non-executive directors in South Africa sit on a number of boards simultaneously due to skills scarcity in the country. The responsibilities of non-executive directors are increasing to the point where there is now greater reluctance from competent personnel to take on the role of non-executive directorships in the companies. The rapid development in corporate governance standards, the increased risk inherent in these positions and the additional time commitment required brings significant responsibilities to non-executive directors. As a result of the above, the pool of talent willing to shoulder these burdens shrinks and the consequence of this is greater upward pressure on the salaries needed to attract competent candidates (PwC 2008).

The issues raised above have negative consequences as they compromise directors' effectiveness and bring their independence and commitment into doubt. Since the Corporate Laws Amendment Act, 2006 (RSA 2006) did not address the above, Dippenaar (2007) suggests that the following functions be incorporated in the King III report:

- The formulation of strategic direction of the company, whether long-term or short-term;
- The drafting of company policies;
- The appointment of CEOs;
- The provision of guidance on the appointment of senior executives;
- The monitoring and supervision of the performance of executive management;

- Ensuring that companies have adequate operational and financial systems of internal control;
- The provision of accountability by means of punctual and sufficiently-detailed reporting to shareholders and other stakeholders; and
- Ensuring that companies adhere to the relevant statutes and comply with other reporting requirements (Dippenaar 2007).

Based on the above discussion of the upcoming King III report on corporate governance, it is clear that the King committee has to take into account some outstanding issues noted above, i.e. those not captured by the Corporate Laws Amendment Act, 2006 (RSA 2006). If the King III report on corporate governance is to make an impact in South Africa's corporate landscape as well as in the world at large, it has to distinguish itself from the King II report (IOD 2002). The King III should also take into account the global change in corporate governance, by considering issues, amongst others, such as the corruption, global warming and globalisation.

3.4.6 Anticipated Company's Act

The Department of Trade and Industry has embarked on the process to completely overhaul and update the Companies Act, 1973 (RSA 1973). The process of overhauling the Companies Act, 1973 (RSA 1973) will be executed in two phases. The first phase is the Corporate Laws Amendment Act, 2006 (RSA 2006) which was signed by the President on 17 April 2007. Phase one addressed a number of urgent matters which are dealt with in this study.

The second phase entails a complete review of the Companies Act, 1973 (RSA 1973) and was recently issued as the Companies Bill, 2007 (RSA 2007). Although some references are made to the Companies Bill (RSA 2007) in section 3.4.4, a detailed discussion does not fall within the scope of this study; refer to section 1.7 where this is identified as a limitation.

The Company's Bill of 2007 (RSA 2007) which is meant to replace all the corporate laws in South Africa is not discussed in detail in this study, because the study is based on the 2006 annual reports of the top-40 JSE listed companies, therefore the Company's Bill, 2007 (RSA 2007) would not have been effected in these (2006) annual reports. A brief timeline for the Company's Bill extracted from Sabinet (2008) is that the Department of Trade and Industry submitted the Companies Bill to the South African cabinet for approval by 31 October 2007. The Bill was introduced to the South African parliament in February 2008 and was enacted in July 2008. After the enactment, the Bill will be promulgated in November/December 2008. The new Companies Act is expected to be implemented on 1 January 2010 (Sabinet 2008).

The Companies Bill, 2007 (RSA 2007) as explained in the Explanatory Memorandum has a five-point statement of economic growth objectives, namely:

- Encouraging entrepreneurship and enterprise development by simplifying the procedures for forming companies and reducing costs associated with the formalities of forming and maintaining a company;
- Promoting innovation and investment in South African markets and companies providing for flexibility in the design and organisation of companies and a predictable and effective regulatory environment;
- Promoting the efficiency of companies and their management;
- Encouraging transparency and high standards of corporate governance; and
- Making company law compatible and harmonious with the best practice jurisdictions internationally. (RSA 2007.)

3.5 JOHANNESBURG SECURITIES EXCHANGE (JSE) AND CORPORATE GOVERNANCE

The JSE's main functions are to raise primary capital and to provide a market where securities can be traded freely under regulated procedures. The license to operate the Stock Exchange in South Africa is granted by the Ministry of Finance. The Financial

Services Board (FSB) is vested with the powers to control the Johannesburg Securities Exchange. The Johannesburg Securities Exchange (JSE) adopted compliance with the King II report (IOD 2002) as one of its listings requirements on 1 September 2003 (Joubert 2004).

The JSE operates in terms of the Stock Exchange Control Act (SECA) of 1985 (RSA 1985). All the rules and acts undertaken by the JSE must be compliant with this Act. According to SECA, 1985 (RSA 1985), the JSE has the power to suspend a participant if it fails to comply with the listings requirements.

It is a duty of the JSE to prescribe the rules and regulations of the Stock Exchange in the form of its listings requirements, and participants (companies) and their directors are expected to comply. If they are not satisfied with the rules or regulations introduced, participants only have 48 hours to lodge grievances against the decisions taken. Participant may request voluntary suspension from the JSE if they face liquidation or judicial processes (JSE 2003: para. 1 (a), (b) & (c)).

Companies are compelled by the JSE to submit a certificate confirming that they still comply with the JSE rules. Failure to comply with this requirement would prompt the JSE to act against the offender. With its powers, the JSE can fine participants for up to R1 million for failure to comply. The JSE can also demand information from any participant even if that information is not required in terms of its listings requirements, so long as the information is in the public interest. Lastly, if the JSE has acted against an offender, it can decide to publish information in this regard on its website (JSE 2003: para. 1 (d) & (e)).

In addition to the above, companies listed on the JSE are compelled to comply with paragraph 3.84 of the listings requirements. According to the JSE's listings requirements (JSE 2003), issuers must comply with the following specific requirements concerning corporate governance and must disclose their compliance therewith in their annual reports:

- That the company has a policy detailing the procedures for appointments to the board. Such appointments must be formal and transparent, and a matter for the board as a whole, assisted where appropriate by a nomination committee. The nomination committee must constitute only non-executive directors, of whom the majority must be independent (as defined in paragraph 3.84 (f) (iii)), and should be chaired by the board chairperson (JSE 2003: para. 3.84 (a));
- The company has a policy evidencing a clear division of responsibilities at board level to ensure a balance of power and authority, such that that no one individual has unfettered powers of decision-making (JSE 2003: para. 3.84 (b));
- The chief executive officer cannot also hold the position of chairperson (JSE 2003: para. 3.84 (c));
- All issuers must, in compliance with the King code, appoint an audit committee and remuneration committee and if required, given the nature of their business and composition of their board, a risk committee and nomination committee. The composition of such committees, a brief description of their mandates, and the number of meetings held and other relevant information must be disclosed in annual reports (JSE 2003: para. 3.84 (d));
- A brief CV of each director standing for election or re-election at the annual general meeting should accompany the notice of annual general meeting contained in the annual report (JSE 2003: para. 3.84 (e));
- The capacity of each director must be categorised as executive, non-executive or independent, using the following as guidelines to determine which category is most applicable to each director (JSE 2003: para. 3.84 (f)). Given the above:

o Executive directors are directors that are involved in the day-to-day management and running of the business and are in full-time salaried employment of the company and/or any of its subsidiaries (JSE 2003: para. 3.84 (f) (i));

o Non-executive directors are directors that are not involved in the day-to-day management of the business and are not full-time salaried employees of the company and/or any of its subsidiaries (JSE 2003: para. 3.84 (f) (ii));

- Independent directors are non-executive directors who:
  - Are not representatives of any shareholder who has the ability to control or materially influence management and/or the board (JSE 2003: para. 3.84 (f) (iii) (1));
  - Have not been employed by the company or the group of which they currently form part in any executive capacity for the preceding three financial years (JSE 2003: para. 3.84 (f) (iii) (2));
  - Are not members of the immediate family of an individual who is, or has been in any of the past three financial years, employed by the company or the group in an executive capacity (JSE 2003: para. 3.84 (f) (iii) (3));
  - Are not professional advisors to the company or the group, other than in the capacity as a director (JSE 2003: para. 3.84 (f) (iii) (4));
  - Are not material suppliers to, or customers of the company or group (JSE 2003: para. 3.84 (f) (iii) (5));
  - Have no material contractual relationship with the company or group (JSE 2003: para. 3.84 (f) (iii) (6)); and
  - Are free from any business or other relationship which could be seen to materially interfere with the individual's capacity to act in an independent manner (JSE 2003: para. 3.84 (f) (iii) (7)).
  - The audit committee must set the principles for recommending the use of external auditors for non-audit services (JSE 2003: para. 3.84 (g)).

From the above, it appears that companies could decide to disclose or not disclose corporate governance information in their annual reports. This is because the King II report was a recommendation not backed by any legislation. For listed companies, corporate governance disclosure was already a requirement since the adoption of the King II report (IOD 2002) as one of the JSE's listings requirements. While companies were compelled to disclose corporate governance information in their annual reports, the

JSE did not have a monitoring device to monitor whether a company's corporate governance statements are a true reflection at a company level. For the purpose of verifying if a company has complied with the corporate governance code, the JSE still relies on the information disclosed in annual reports.

It is also important to note that the Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 53 (sec. 440P)) has come up with the establishment of a Financial Reporting Standards Council (FRSC), which will have far-reaching powers and formidable resources for pursuing non-compliant companies and their directors. The Financial Reporting Standards Council (FRSC) is expected to take over from the GAAP Monitoring Panel. The Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 38 (sec. 287)) provides that "a public interest company which issues a financial report that fails to comply with a financial reporting standard and every director of the company, who has signed or was party to the financial report, shall be guilty of an offence". (RSA 2006: sec. 38 (sec. 287)).

3.6 SUMMARY AND CONCLUSION

In the first section of this Chapter corporate sins were discussed. A manager who is sluggish, greedy, fearful and who promotes his/her interest above the interest of the company is committing a corporate sin. To reduce corporate sins, directors and managers of a company have to fully disclose all material facts about the state of affairs of a company, including non-financial information.

Information that is transmitted to users needs to be reliable and allow users to formulate informed decisions. The benefits of reliable information amongst others are: potential investors will make informed decisions to invest in a company; government authorities will be able to verify if the company adheres to the relevant laws; potential employees will be able to decide if a company takes good care of its employees; and existing stakeholders will be assured that a company reports and applies good governance in its activities.

Chapter 3 discussed the current corporate governance reforms in South Africa by highlighting the most important changes from the Company's Act, 1973 to the recent Corporate Laws Amendment Act, 2006. The most notable changes included, amongst other things are: identification of companies; circumstances in which a company may provide financial assistance for the purchase of its own shares; disposal of the undertaking or the greater part of the asset, audit committees for public interest companies; new obligations on companies and auditors in order to promote the independence of auditors and legal backing for accounting standards currently used for financial reporting.

It was also noted that the Company's Act, 1973 had more than thirty years in existence. Even though the Act has been amended a couple of times since it was passed, the basic principles that established the accountability arrangements between the providers (principals) and stewards (agents) of capital have remained essentially unchanged. These fundamental arrangements are based on English law. Corporate failures such as those of Fidentia exposed the corporate governance framework as incapable of effectively and efficiently dealing with unethical company directors and officers. The Company's Act, 1973 was also not designed to support the openness, transparency, fairness and accountability principles, which the King I report addressed. Based on this, the Company's Act, 1973 had to be updated to accommodate the recommendations of the King II report.

This Chapter further discussed the much awaited King III report and the issues it will have to address for it to have an impact. Amongst the issues to be addressed by the King III report are: the provision of guidelines with regards to the formulation of strategic direction of the company, whether long-term or short-term; drafting of company policies; appointment of CEOs; provision of guidance on the appointment of senior executives; guidelines on monitoring and supervising the performance of executive management; guidelines ensuring that the company has adequate operational and financial systems of internal controls; provision of guidelines on accountability by punctual and sufficiently-detailed reporting to shareholders and other stakeholders; and provision of guidelines that

will ensure that the company adheres to relevant statutes and complies with other reporting requirements. A brief discussion of the Company Bill was also presented and its timeline was given.

From the issues discussed above, it is clear that corporate governance is a critical element in addressing greed, corruption and other corporate sins committed by directors and other company officials. These corporate ills are a threat to shareholders' capital. The newly introduced Laws attempt to reduce the temptation of committing the above-mentioned corporate sins by legalising corporate governance in South Africa and thereby legalising penalties associated with the unwanted behaviour. The KPMG survey notes that South African companies do not comply with the good spirit of the King code and that they merely comply by "ticking off" (KPMG 2006: 2). The questions that will be addressed in the Chapters to follow and which underpin this research are:

- How useful to stakeholders is the corporate governance information disclosed in the annual report of a company?
- Do the top-40 JSE listed companies comply with the King II report by disclosing all the minimum corporate governance information in annual reports?

Chapter four discusses questions that will be used in the assessment of the usefulness of corporate governance information disclosed in the annual report of the top-40 JSE listed companies. The checklist questions in Appendix A are based on the requirements of the King II report and the Corporate Laws Amendment Act, 2006 which became effective in 2007.

CHAPTER 4

RESEARCH DESIGN

4.1 INTRODUCTION

Chapter two of this study discussed the agency problem, a condition which provides the theoretical background for present-day corporate governance practices. This was followed by a discussion of the development of corporate governance in South Africa and some of its major trading partners. Chapter three reflected on the South African corporate governance framework and discussed recent corporate governance reforms which enhanced corporate governance reporting.

The underlying research problem of this study is to assess whether current corporate governance disclosures in the annual reports of South Africa's top-40 listed company's annual reports provide useful information from which users can make decisions. This requires an assessment of corporate governance reports disclosed in the annual reports. This Chapter forms the basis of that assessment.

The remainder of this Chapter will discuss the research methodology followed in this study and the development of the questions that have been incorporated in the research instrument for this study, which is a checklist used to assess the usefulness of corporate governance information disclosed in the annual report of a company. The application of the checklist to the corporate governance reporting of South Africa's top-40 companies will follow in Chapter 5.

4.2 THE RESEARCH INSTRUMENT

4.2.1 CHECKLIST

The checklist forms the research instrument of this study. It is based on the corporate governance requirements of the King II report (IOD 2002) and the Corporate Laws Amendment Act, 2006 (RSA 2006). The objective of the checklist is to analyse the information disclosed in the corporate governance statements of the annual reports of the top-40 listed companies in South Africa and to assess the usefulness of this information for users when making decisions. A copy of the research instrument, the checklist, appears in Appendix A at the back of this dissertation.

The steps followed in assessing these annual reports are outlined below as:

- Identifying the top-40 JSE-listed companies using rating agencies. The information on the top-40 listed companies was taken from I-Net Bridge on the 17th of October 2007 (I-Net Bridge 2007).
- Downloading the annual reports of the top-40 JSE listed companies from their websites.
- Performing content analysis on each annual report (see Table 4.1 and Appendix C) by identifying the relevant sections in the annual reports which report on corporate governance issues.
- Reviewing the relevant sections according to the key issues as per the checklist in Appendix A.
- Scoring the disclosures in the relevant sections in accordance with the criteria set out in Table 4.2 below.
- Entering the data in accordance with the scoring spreadsheet as per Appendix B at the back of this dissertation.

- Checking the scoring by selecting 20 companies randomly and rescoring the applicable reports once again to ensure consistency in the scoring procedure. This step is a quality control procedure.
- Presenting the results graphically, a step which follows in Chapter 5.

4.2.2 USERS OF ANNUAL REPORTS/FINANCIAL STATEMENTS

This study aims to assess whether the corporate governance disclosures in the top-40 JSE listed companies' annual reports provide useful information for users' decision making. The IASB framework (2007: framework para. 9) has identified the users of annual reports/financial statements as present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. These users make use of financial statements in order to satisfy some of their different needs for information. According to the IASB framework (2007: framework para. 9) the needs of the above users include the following:

- Investors who are the providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the entity to pay dividends.
- Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.
- Lenders are interested in information that enables them to determine whether their loans, and the interest attached to them, will be paid when due.
- Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an entity over a shorter period than lenders unless they are dependent upon the stability of the entity as a major customer.

- Customers have an interest in information about the stability of an entity, especially when they have a long-term involvement with, or are dependent on the entity.
- Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They also require information in order to regulate the activities of entities, determine taxation policies and for compiling national income and similar statistics.
- The public is affected by entities in a variety of ways. For example, entities may make a substantial contribution to the local economy in many ways, including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing them with information about the trends and recent developments in the prosperity of the entity and the range of its activities. (IASB 2007: framework para. 9.)

4.2.3 THE USEFULNESS OF ANNUAL REPORTS/FINANCIAL STATEMENTS

There are various ways in which a company communicates with its shareholders. Some of the ways include media releases, newsletters, websites, bulletins and annual reports. The diverse nature of information generated by companies makes it difficult for analysts and other company stakeholders to identify a complete set of corporate governance reports. Even though there are a vast number of separate corporate governance reports on company websites, this study focuses on the disclosures of corporate governance statements in annual reports. The justifications for the above are as follows:

- According to Wiseman (1982) the annual report is widely recognised as a principal means for corporate communication of activities and intentions and has been the source for virtually all previous corporate research. Barlett and Chandler (1997) agree with Wiseman (1982) that corporate annual reports are seen as an important device for financial communication between management and stakeholders, however, Bartlett and

Chandler's (1997) survey suggests that the annual report is still not widely read, i.e. annual reports are not fully understood by their users.

- Savage (1988) argues that annual reports are an important channel by which corporations can communicate with interested stakeholders and they are considered to be a logical medium for communicating corporate attempts at legitimisation of environmental activities.
- Thomas and Kenny (1996) view annual reports as the least costly method of communicating with stakeholders. Wilmshurst and Frost (2000) argue that the annual report is a statutory report containing both statutory and voluntary disclosures, which is produced regularly and can be easily accessed.
- Savage (1998), as well as Savage and Cataldo (1999) all find that corporations are increasingly using their annual reports to disclose information about their social actions, particularly those relating to the natural environment.

Based on the above discussion it is of critical importance that these annual reports are useful to users. The Oxford English Dictionary (Oxford 2000: 1321) states that an item is useful when it serves a use or purpose. For annual reports to be useful, they must serve a specific purpose. According to the IASB Framework (IASB 2007: framework para. 12), "The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions". From the above, it is therefore clear that financial statements are useful if they provide information to users for the purposes of making sound economic decisions.

The main drivers of usefulness of information provided in financial statements are the qualitative characteristics of annual financial statements. The four principal qualitative characteristics of information captured in financial statements as identified in the IASB Framework (IASB 2007: framework para. 24) are:

- Understandability;
- Relevance;
- Reliability; and

- Comparability.

With reference to the IASB Framework (IASB 2007: framework para. 24), the above characteristics are discussed individually below.

- Understandability: For the information contained in the financial statement to be useful, it must be readily understood by the wide range of users of financial statements. For this reason, users of financial statements are assumed to have knowledge of business, economic activities and accounting and they must be prepared to study financial statements with reasonable thoroughness.
- Relevance: For the information captured in financial statements to be useful, it must meet the decision making needs of the users of financial statements. Information contained in financial statements is deemed to be relevant if it influences the decisions of users of financial statements.
- Reliability: For the information contained in the financial statements to be useful, it must be reliable. The information contained in the financial statements is deemed to be reliable if it is free from material error and bias and users of financial statements can depend on it when making decisions. Other matters relating to the reliability of financial information are faithful representation, substance over form, neutrality, prudence and completeness. Inherent to the nature of the qualitative characteristics of reliability and relevance are conflicting issues that need to be balanced in order to best satisfy the needs of the users of financial statements, for example, the more time is spent in an attempt to improve the reliability of financial information, the less relevant the financial information will probably become to users.
- Comparability: For information contained in financial statements to be useful, it must be comparable to the financial information of the company presented at an earlier date and the financial information of other companies. This facilitates the identification of trends over time as well as the evaluation of companies in relation to one another (IASB 2007: framework para. 24).

To evaluate each of the above qualitative characteristics in respect of corporate governance disclosures is a study in its own right. In this study, content analysis based on the requirements of the King II report (IOD 2002) and the Corporate Laws Amendment Act, 2006 (RSA 2006) will be used to evaluate the usefulness of corporate governance statements disclosed in the annual reports of the top-40 JSE listed companies. The justification of the use of this method is set out below in section 4.3.

4.3 THE RESEARCH METHODOLOGY - CONTENT ANALYSIS

In order to determine the amount and the quality of information disclosed in each section and decide if a company has fully disclosed, not disclosed or partly disclosed the required corporate governance information in its annual report, the empirical method known as "content analysis" is used. Content analysis can be defined as a systematic, replicable technique for compressing many words of text into fewer content categories based on explicit rules of coding (Berelson 1952, Krippendorff 1980 & Weber 1990). According to Ingram and Frazier (1980: 615) the methodology of content analysis involves the selection of analytical categories within the context of the content material.

Holsti (1969: 14) offers a broader definition of content analysis as "any technique for making inferences by objectively and systematically identifying specified characteristics of messages". According to Stemler (2001), the technique of content analysis is not restricted to the domain of textual analysis, but may be applied to other areas such as coding student drawings (Wheelock, Haney & Bebell 2000), or coding of actions observed in videotaped studies (Stigler, Gonzales, Kawanaka, Knoll & Serrano 1999). Stemler (2001) argues that in order to allow for replication, the technique can only be applied to data that are durable in nature.

According to Mouton (2005: 165), content analysis is a study that analyses the content of texts or documents such as letters, speeches and annual reports. Cronje (2007: 141) states that “content” refers to words, meanings, pictures, symbols, themes, or any message that can be communicated.

From the above discussion of content analysis, it becomes clear that it enables researchers to sift through large volumes of data in a systematic fashion, with relative ease (US General Accounting Office 1996). Content analysis can also be a useful technique for discovering and describing the focus of individual, group, institutional, or social attention (Weber 1990), while allowing inferences to be made, which can then be substantiated using other methods of data collection. Krippendorff (1980) notes that ”much content analysis research is motivated by the search for techniques to infer from symbolic data what would be either too costly, no longer possible, or too obtrusive by the use of other techniques” (Krippendorff 1980: 51).

Krippendorff (1980) further states that “content analysis is a research technique for making replicable and valid inferences from data according to their context”. According to Guthrie and Parker (1990) content analysis assumes that the content categories identified in written messages of annual reports have manifest meanings that can therefore be categorised. Further to this, Guthrie and Parker (1990) note that content analysis has been widely employed in studies on annual reports in the areas of corporate social and environmental reports.

Hackston and Milne (1996) argue that the application of content analysis in prior studies has measured disclosures in different units, i.e. number of sentences, words and pages. In their study, Milne and Adler (1999) consider the number of sentences as the most appropriate measure of disclosure and as the most appropriate basis for coding and analysis. Milne and Adler (1999) believe that variability in sentence length is not considered a factor affecting the analysis of content from a coding perspective; however, they regard the use of a word as a unit of measurement as difficult, because the interpretation of individual words out of context may result in different meanings.

Unerman (1999) concurs with the above by arguing that the use of sentences overcomes the problem of using words and removes some of the judgement required. Milne and Adler (1999: 243), however, acknowledge that studies do not consistently use sentences to both code and count (measure) the amount of disclosure. Instead, according to them (Milne & Adler 1999: 243) studies use sentences to code and words or areas of a page to count (measure) disclosures. Nevertheless they (1999: 243) maintain that fewer errors are likely to arise in counting sentences than counting words.

Unerman (1999: 677) notes two limitations of content analysis as discussed above. Firstly, studies focusing exclusively on annual reports, risk capturing an incomplete picture of the information disclosed, and thus an incomplete picture of the practices they are attempting to study. Secondly, any content analysis study which adopts measurement techniques which only capture words and numbers, while ignoring pictures, graphics and different typeface sizes is also likely to result in an incomplete representation (Unerman 1999).

According to Unerman (1999: 678), the above reservations are important; because one of the key assumptions underlying content analysis is that the volume of disclosure represents the importance of the items disclosed. Cronje (2007) supports the notion that measurement in sentences may have limitations, because even if it is carried out with greater accuracies than measurement in proportion of a page, it is likely a less relevant result than the latter.

Smith and Taffler (1999: 627) identify two generic approaches to content analysis, one is form-orientated (objective) analysis, which involves routine counting of words or concrete references. The second one is known as meaning-orientated (subjective) analysis, which focuses on the analysis of the underlying themes in the texts under investigation (Smith & Taffler 1999).

Weber (1990: 37) argues that word categories inferred from covariation among high frequency words are more reliable than themes. Krippendorff (1980: 63) warns that for many content analyses, thematic units require users' judgement in the determination of the hidden messages conveyed in the narratives, but suggests that this approach may be preferable despite the difficulties in its application to content analysis in practice.

The US General Accounting Office (1996) notes the three problems that could be encountered when documents are being assembled for content analysis. These problems are:

- Firstly, when a substantial number of documents from the population are missing, the content analysis must be abandoned;
- Secondly, inappropriate records (e.g., ones that do not match the definition of the document required for analysis) should be discarded, but a record should be kept of the reasons; and
- Finally, some documents might match the requirements for analysis but just be un-codable because they contain missing passages or ambiguous content (US General Accounting Office 1996).

Based on the above discussion of content analysis, both form-orientated (based on words) and meaning-occurrence (based on description) (see Appendix C) content analysis methods represented a widely recognised research method, which can be used to assess disclosures of corporate governance statements in the annual reports of South Africa's top-40 JSE listed companies. For the purpose of this study, words are taken to indicate semantically equivalent textual units, including synonyms, idioms and phrases (Weber 1990: 22) and theme clusters of words with different meanings or connotations when taken together are taken to refer to some theme or issue (description) (Weber 1990: 37).

Results obtained from both form-orientated and meaning-occurrence content analysis will be benchmarked to the requirements of the King II report (IOD 2002) and Corporate Laws Amendment Act, 2006 (RSA 2006) outlined in Appendix C of this study. This is done in order to establish whether corporate governance statements reflected in the top-40 JSE listed company's annual reports have been fully disclosed, partly disclosed or not

disclosed at all, as per Table 4.2 and the requirements set out in Appendix C. Below is the content analysis Table (see Table 4.1) and the guidelines of how a company's annual reports will be scored (see Table 4.2).

TABLE 4.1 – CONTENT ANALYSIS

Description of disclosure requirement	Number of categories majored (sub-categories)

1. Board and its directors	• Charter
	  o Board responsibilities
	  o Board size
	  o Board composition
	• Meetings
	• Board committees
	  o Audit committee
	  o Remuneration committee
	  o Risk management committee
	  o Other committees

2. Risk management and internal controls	• Risk management information i.e. headline risk areas • Internal control adequacy
3. Internal audit	• Internal audit independence • Relationship between risk management unit and internal audit unit
4. Integrated sustainability reporting	• Health and safety issues • Environmental issues • Social investment spending

	• Employment equity • Human capital development • Black economic empowerment
5. Accounting and auditing	• Interactions between internal and external auditors • Selection of external auditors • Audit report
6. Relation and communication with company shareholders	• Shareholders participation thus voting powers • Shareholders duties and powers
7. Company's code of ethics	• Code of ethics • Whistle blowing

The assessment of corporate governance reporting in the annual reports of the top-40 JSE listed companies is carried out using the descriptions and the categories provided in Table 4.1 above as per the King II (IOD 2002) requirements as well as the Corporate Laws Amendment Act, 2006 (RSA 2006) requirements. In searching for the information that should be disclosed in the annual reports under the descriptions and categories mentioned above, descriptions and the key word/s highlighted in Appendix C are to be used.

TABLE 4.2 – CONTENT ANALYSIS – GUIDELINE TABLE

	FULLY DISCLOSED	NOT DISCLOSED	PARTLY DISCLOSED
Guideline	If the required information according to Appendix C is disclosed under its category in a paragraph, a few paragraphs or a full page and this information contains all the required information as well as voluntary disclosures for that category, the item is ticked as **Yes** in the checklist.	If there is no disclosure at all of the minimum required information according to Appendix C, the item is ticked as **No** in the checklist.	If the minimum required information is disclosed according to Appendix C, however this information is not disclosed separately under its category, and is not disclosed in detail i.e. appears in one sentence that does not give adequate details, the item is ticked **Partly** in the checklist.

To score the top-40 JSE listed companies as fully disclosed, partly disclosed or not disclosed the required corporate governance information in their annual reports, Table 4.2 will be used in conjunction with the requirements of the Corporate Laws Amendment Act, 2006 (RSA 2006) and King II report (IOD 2002) set out in Appendix C of this study. This appendix outlines requirements in categories according to the King II report (IOD 2002) and the Corporate Laws Amendment Act, 2006 (RSA 2006). The information obtained here will be disclosed in the spreadsheet provided in Appendix B to map out and determine the results.

A discussion of minimum corporate governance information as based on the King II report (IOD 2002) and the Corporate Laws Amendment Act, 2006 (RSA 2006) that should appear in the annual report of a company follows below. The discussion is supplemented by empirical evidence that has been undertaken in other countries in each sub-topic. Based on the above-mentioned, the checklist question/s on each sub-topic is presented. A discussion on the usefulness of disclosing information in the annual report

and the manner in which such disclosure will assist users in their decision-making is also included.

4.4 THE BOARD AND ITS DIRECTORS

According to the King II report (IOD 2002), South African companies need to have a unitary board structure which comprises of both executive and non-executive directors, preferably with a majority of non-executive directors, of whom a sufficient number should be independent of management in order to ensure the protection of minority shareholders' interests (IOD 2002). Section 269A of the Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 24 (sec. 269A)) defines an independent director as "a director who is not a member of the immediate family of any individual who has been involved in the day-to-day management or been a full-time employee in the past three years".

The Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 24 (sec. 269A)) further requires that a director will act "independently" if he/she exercises his/her judgment impartially and he/she is not related to the company or its shareholders, customers, suppliers or other directors in a way that would lead a third party to conclude that his/her integrity, impartiality or objectivity is compromised by that relationship. The Law defines a "non-executive" director as a director who is not involved in the day-to-day management of the company and has not been a full-time salaried employee of the company within its past three financial years (RSA 2006: sec. 24 (sec. 269A)).

Further to the above requirements of the King II report (IOD 2002), the board of directors must retain full and effective control over the company and be responsible for monitoring management in respect of the implementation of board plans and strategies. The King II report (IOD 2002) requires that each company be headed by an effective board with adequate capacity to lead the company. The board also needs to develop a charter that sets out its responsibilities to ensure that the company complies with all relevant laws, regulations, and codes of business ethics, identifies risks and key performance indicators of the company. The charter should ensure that all of the above are monitored regularly. The board of each company should establish both the remuneration and the audit

committees which both consist of and are chaired by independent non-executive directors. All necessary information including the number of meetings attended by each director should be disclosed in the annual reports of a company. (IOD 2002.)

Jensen (1993) provides the following seven proposals that would enable the board to become an effective control mechanism:

- First, board cultures must be changed to emphasise frankness and truth instead of politeness and courtesy so that CEOs do not have the influence to control the board and escape scrutiny;
- Second, board members must have free access to all relevant information and not just the information selected by CEOs. Then the board members must have the expertise to evaluate this information;
- Third, legal liabilities must be altered so that directors have the appropriate incentives to take actions that create value for the company, not only reduce the risks of litigation;
- Fourth, management and board members should have significant equity holdings in the company to promote value maximisation for shareholders;
- Fifth, boards should be kept small (seven or eight members) so they can function more efficiently and not be controlled by CEOs. Similarly, CEOs should be the only insiders because other insiders are too easily influenced by CEOs;
- Sixth, the board should not be modelled after the democratic political model that represents other constituencies in addition to shareholders; and
- Finally, the CEO and the chairman of the board should not be the same person. The role of investors that hold large debt or equity positions in the company and actively seek to participate in the strategic direction of the company should therefore be expanded (Jensen 1993).

With regard to the management and board member equity ownership, Jensen (1993) suggests that many problems occur because neither managers nor directors normally own a substantial proportion of the firm's equity, which decreases the incentives of directors and officers to pursue shareholders' interests and causes the agency problem.

The agency theory discussed in Chapter 2 of this study argues that better corporate governance should lead to higher stock prices or better long-term performance, because managers are better supervised and agency costs are decreased. However, Gompers, Ishii, and Metrick (2001) argue that the evidence of a positive relationship between corporate governance and firm performance may have little to do with the agency theory explanation, but the manner in which managers and directors are remunerated by a company, which will in turn reduce the motivation of directors and managers to pursue the causes of the agency problem.

4.5 PREVIOUS RESEARCH ON BOARD CHARTER

4.5.1 Previous research on board responsibilities

The King II report (IOD 2002) requires that the board develops a charter setting out its responsibilities, which should be disclosed in its annual report. The board should also give the company strategic direction, appoint the CEO and ensure that there is succession planning for key positions in a company. Further functions of the board include ensuring that the company complies with all relevant laws, codes and regulations of business practice and that it establishes the code of conduct addressing conflict of interests and the identification of all key risks that can affect the company (IOD 2002).

Dalton and Dalton (2005: 95) argue that an effectively comprised board is one that represents an effective balance between directors with the combined skill set and inclination to dispatch their multiple board responsibilities. For them, the independence of a director neither guarantees director quality nor does it ensure higher firm performance, the near exclusive focus on board independence is rather like evaluating the board through a pinhole as compared to a wide angle (Dalton & Dalton 2005).

In their study on the functions of the board of directors in the Taiwanese corporate governance system, Solomon, Wei-Lin, Norton and Solomon (2003) find that the board of directors constitutes the most important instrument in Taiwanese corporate governance. Their findings also endorse the important role played by outside directors in the corporate governance system in Taiwan. According to their study (Solomon *et al* 2003), Taiwanese companies endorse the agency theory perspective on corporate governance as they consider the presence of outside directors as improving corporate accountability to shareholders.

4.5.2 Previous research on board size

Both the King II report (IOD 2002) and the Corporate Laws Amendment Act, 2006 (RSA 2006) are silent on the size of the board, however, the King II report (IOD 2002) notes that every board should consider whether its size, diversity and demographic composition make it effective in its fiduciary duties.

Empirical evidence on board size has produced inconsistent findings over time. For instance, Jensen (1993) proposes that a smaller number of board members produces a more effective control mechanism and plays a more important control function, whereas larger boards have difficulty coordinating their efforts which leaves managers free to pursue their own goals.

Jensen (1993) warns that a smaller board might be easier for the CEO to influence and a larger board would offer a greater breadth of experience. The impact of board size on the corporate control mechanism is not obvious, but the arguments presented above suggest that a smaller board would result in closer alignment with shareholder interests in a company.

According to Yermack (1996), there is a fairly clear negative relationship between board size and firm value. An excessively large board of directors is likely to be less effective in substantive discussion of major issues (Jensen 1993 & Lipton & Lorsch 1992) and is highly likely to suffer from free-rider problems among directors in their supervision of management (Hermalin & Weisbach 2001).

Kyereboah-Coleman and Biekpe (2007) found that while a firm level risk has a positive relationship with board size, CEO tenure has a negative correlation with board size, and that firms with larger institutional shareholding employ fewer outside directors. However, they warn that their study has its own limitations as its sample size is small.

In their study of boards of directors, Dalton and Dalton (2005: 95) conducted a meta-analysis study on board size, based on 131 available studies. Their study finds there is a strong link between larger boards and stronger financial performance in firms. The information that was analysed in their data was based on both accounting and market-based firm performance measures. They, however, warn that board size should be assessed relative to current board-size ranges. Dalton and Dalton (2005: 95) further admit that they were unable to pinpoint an exact modulation point where boards become too large and unwieldy. They, however, believe that bigger is better when it comes to board size (Dalton & Dalton 2005).

4.5.3 Previous research on board composition

According to the King II report (IOD 2002), the board of directors should consist of a combination of independent non-executive directors, non-executive directors and executive directors. Woo-Nam and Nam (2004) agree that the board of directors of a company should also be composed of outside directors. Weisbach (1988) supports the King II requirements (IOD 2002) on outside directors. Further to this, Woo-Nam and Nam (2004) maintain that outside directors represent shareholder interests better than inside directors.

Empirical studies on board composition of a firm are inconclusive. Some studies find better performance for firms with boards of directors dominated by outsiders (Ellingson 1996, Millstein & MacAvoy 1998, Rosenstein & Wyatt 1997 & Weisbach 1988). On the other hand, other empirical studies find no such relationship in terms of accounting profits or firm value (Bhagat & Black 1999, Hermalin & Weisbach 1998, Johnson 1996, Klein 1998, Mehran 1995, Rosenstein & Wyatt 1997 & Weir & Laing 2001).

Jensen (1993) argues that corporate officers who report to the CEO cannot be effective monitors because the possibility of injustice is high. Therefore, the officers of the corporation should not serve on the board. Kesner, Victor, and Lamont (1986) refer to this point as the "outsider dominance perspective". To the contrary, outsiders sometimes do not understand the complexities of the company and are technically ineffective monitors. According to Jensen (1993) when outsiders represent a large number of diverse interests, they may restrict the economic flexibility of the firm and produce conflicts between the board and management.

Woo-Nam and Nam (2004) argue that boards dominated by insiders are not expected to play their role as effective monitors and supervisors of management. This is particularly so when the board chairperson is also the firm's CEO. In the same manner as Woo-Nam and Nam (2004), Jensen (1993) argues that the CEO should not have a dual position as chairman of the board because the CEO may not separate personal interests from shareholder interests. The function of the chairman of the board is to conduct board meetings and supervise the evaluation and compensation of the CEO (Jensen 1993).

A major premise of Jensen (1993) is that the CEO should pursue the interests of shareholders. The argument against a combination of the chairman of the board and the CEO is that management will become too powerful and not have interests aligned with shareholders. The fact that a CEO would be able to control other officers on the board follows the same line of reasoning. A parallel consideration is the equity ownership position of the CEO. The amount of equity a CEO holds should increase the alignment of the interests of the CEO with the interests of shareholders. This would likely reduce the effectiveness of the control mechanisms of the governance structure. The issue of CEO duality has received considerable attention because the practice is commonly observed in many large corporations (Kesner *et al* 1986). In most corporations and prior to the 1997 East Asian crisis, the above was a common practice in East Asia (Woo-Nam & Nam 2004).

In their study of the determinants of board composition, Hermalin and Weisbach (1988) find that changes in board composition are influenced by the CEO succession process and firm performance. Their findings further suggest that non-executive directors are more likely to leave the board after a firm performs poorly and when a firm discontinues business. Contrary to Hermalin and Weisbach (1988), Bathala and Rao (1995) examine board composition determinants in an agency framework. Their conclusion is that board composition is a substitute for alternative agency mechanisms such as debt, dividend policy, and insider ownership.

Weisbach (1988) argues that outside directors provide firms with windows or links to the outside world, thereby helping to secure critical resources and expand networking. While outside directors bring a breadth of knowledge and expertise to the firm, they may have a limited understanding of the firm's business, which would impede their ability to guide and supervise management (Donaldson & Davis 1991), and could even stifle strategic action and result in excessive monitoring. Based on this, the finding that board composition does not matter much may not be surprising (Donaldson & Davis 1991).

Black (2000) argues that Donaldson and Davis' (1991) results likely stem from relatively small variations in corporate governance practices in US and other industrial countries. According to Black (2000), a host of factors, which are not limited to the board composition, affect firm performance. For instance, Bhagat and Black (1999) find that companies with more independent boards do not perform better than other companies. Therefore, according to them, it is unlikely that board composition has a direct impact on firm performance (Bhagat & Black 1999). Heracleous (2001) suggests that different types of organisations may need different corporate governance practices and suggests that more attention should be given to behavioural observations and in-depth interviews.

The substantiation of the above is given by the Liang and Lee (1999) survey. They surveyed a sample of 228 small private firms in Shanghai in the People's Republic of China. According to the survey conducted, the presence of outside directors is positively associated with higher returns on investment. However, Liang and Lee (1999) could not find such a relationship for board size or the separation of the positions of CEO and board chairperson.

4.6 PREVIOUS RESEARCH ON BOARD MEETINGS

The King II report (IOD 2002) requires that the board meet regularly, at least once a quarter if not more frequently as circumstance require. The board should also disclose in the annual report the number of meetings each year and the details of attendance of each director at such meetings (IOD 2002).

Lipton and Lorsch (1992) suggest that the most widely shared problem by most companies is that director's lack the time to carry out their duties. Similarly, Conger, Finegold and Lawler III (1998) argue that board meeting time is an important source of improving the effectiveness of a board. The above views are substantiated by recent criticisms of directors who take many outside directorships, confounding their ability to attend meetings regularly, thereby failing to monitor management of a company effectively (Byrne 1996 & NACD 1996). The implication by the above authors is that the board of directors which meets more frequently is more likely to perform its duties in accordance with shareholders' interests.

Contrary to the view presented by Lipton and Lorsch (1992) and Conger *et al* (1998) regarding board meetings, Jensen (1993) argues that board meetings are not necessarily useful. This, according to Jensen (1993), is because the limited time that outside directors spend together is not used for the meaningful exchange of ideas amongst themselves or with the management of a company. The above, Jensen (1993) argues arises because of the fact that CEO's almost always set the agenda for board meetings (Jensen 1993).

From the above, it is clear that Jensen (1993) suggests that boards of directors should be relatively inactive, and that boards are usually only forced to maintain higher activity levels in the presence of problems. Vafeas (1999) argues that if what Jensen (1993) says, is something to go by, then board meetings serve as a fire-fighting device rather than as a proactive measure for improved governance. Further to this, Vafeas (1999) states that while the consequences of higher board activity are unclear, higher board activity is the likely corporate response to poor performance.

In his paper, Vafeas (1999) suggests that the evidence regarding the significance of board meeting frequency carries a potentially important governance implication. Vafeas' (1999) paper examines the importance of board meeting frequency by testing whether firms with boards that meet more frequently outperform firms with inactive boards. His study is divided into the determinants of board meeting frequency and the association between this frequency and firm value for 307 firms between the years 1990 and 1994.

Vafeas' (1999) results reveal that board meeting frequency is related to corporate governance and ownership characteristics, in line with contracting and agency theory. According to him (1999), companies with boards that meet more frequently are valued less by the market. According to Vafeas (1999), this is a finding that seems to be driven by share price declines, followed by higher meeting frequencies. Vafeas' (1999) results further reveal that years with an abnormally high meeting frequency are followed by improvements in operating performance. Additionally, performance improvements are most significant for firms experiencing poor prior performance and firms not engaged in corporate control transactions (Vafeas 1999).

Vafeas' (1999) paper notes the following factors regarding board meetings and increasing the firm's value:

- Firstly, there are costs associated with board meetings, including managerial time, travel expenses, and directors' meeting fees. On the other hand, there are also benefits, including more time for directors to confer, set strategy, and monitor management.

- Secondly, if firms have fewer board meetings than are necessary, overemphasising costs, board meeting frequency will be positively associated with firm value. Evidence in this direction suggests that increasing meeting frequency is one fairly inexpensive way for firms to increase value. If, by contrast, benefits are overemphasised, board meeting frequency will be negatively related to firm value.
- Finally, if a firm is reasonably efficient in setting the frequency of its board meetings, depending on its environment, it will attain economies in agency costs. For such a value-maximising firm, the net effect of a marginal change in board meeting frequency on firm value should be close to zero. In summary, the relationship between board activity and firm value is an empirical question (Vafeas 1999).

4.7 PREVIOUS RESEARCH ON BOARD COMMITTEES

According to the King II report (IOD 2002), each board should have an audit and a remuneration committee. The audit committee should have at least two independent non-executive directors. The majority of members of the audit committee should be financially literate. The committee should be chaired by the independent non-executive director who is not the chairman of the board. The audit committee should have written terms of reference, which deal with its membership, authority and duties (IOD 2002).

The Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 24 (sec. 269A)) requires that every financial year the board of directors of a widely held company appoint a new audit committee. According to the Act, a widely held company needs to have an audit committee consisting of at least two members. The amendment provides that, only non-executive directors who act independently can be members of the audit committee. This means that an executive director cannot be a member of the audit committee (RSA 2006: sec. 24 (sec. 269A (3), (4) (b) & (c))).

In his article, Klein (1998) demonstrates a linkage between firm performance and board composition by examining the committee structure of boards and the directors' roles within these committees. According to Klein (1998), there is little association between firm performance and overall board composition. However, Klein (1998) reveals that there are significant ties between firm performance and the manner in which boards are structured.

Klein's (1998) findings reveal, firstly, a positive relationship between the percentage of inside directors on finance and investment committees and accounting and stock market performance measures. Secondly, firms that significantly increase inside director representation on these two committees (finance and investment committees) experience significantly higher contemporaneous stock returns and returns on investments than firms decreasing the percentage of inside directors on these committees (Klein 1998).

Kohler (2005) analyses the nature of audit committees in Germany and finds that, due to legal restrictions, audit committee formation in Germany is not only a matter of enhancing monitoring effectiveness, but also a means of increasing Supervisory Board efficiency. Her study further reveals that the size of audit committees in Germany significantly influences audit committee composition, and that tasks that are mainly auditor-related are treated as supplementary (Kohler 2005).

In South Africa, a recent survey undertaken by Ernst and Young (2005: 2) on board committees indicates that the compensation paid to audit committee members is proportionate to their responsibilities and the risks associated with their positions. Ernst and Young (2005: 1), however, warns that the effects and implementation of the King II report (IOD 2002) on audit committee performance have not been clearly measured even though there are currently adequate global benchmarks and measures available for measuring audit committee performance and progress.

Klein (2006) examines whether audit committee and board characteristics are related to earnings management by firms. Results obtained by Klein (2006) reveal a non-linear negative relationship between audit committee independence and earnings manipulation. For Klein (2006) these results are significant only when the audit committee has less than a majority of independent directors. Empirical evidence presented by Klein (2006) also reveals that earnings management is positively related to whether the CEO sits on the board's compensation committee. Klein's (2006) results reveal that earnings management is negatively related to the CEO's shareholdings and to whether a large outside shareholder sits on the board's audit committee. Klein (2006) concludes that this result suggests that boards structured to be more independent of the CEO may be more effective in monitoring the corporate financial accounting process.

From the above discussion of the board and its directors, it appears that the board is an important element of corporate governance in a company. It also appears that the board has to fulfil its responsibilities by compiling its charter which explains the strategic direction of the company and ensures that the company complies with all relevant laws, codes and business practice regulations.

4.8 CHECKLIST QUESTIONS ON THE BOARD AND ITS DIRECTORS

To validate the ability of the board of directors to discharge its duties effectively and its compliance with the corporate governance framework, the following questions with regard to disclosure of board information in the annual reports of a company has been included in the verification checklist (refer to Appendix A (1)):

- Does the annual report of a company contain information relating to the board charter that:

  - clearly sets out the responsibilities of the board;
  - clearly sets out the board size; and
  - clearly sets out the board's composition?

- Does the annual report contain information relating to the number of meetings held by the board of directors?
- Does the annual report of a company contain information relating to board committees such as:

  - information relating to the audit committee;
  - information relating to the remuneration committee;
  - information relating to the risk management committee; and
  - information relating to other board committees?

Disclosure of information regarding the first question determines the board's vision about the company and its size and composition. Disclosure of this information in the annual report of a company will assist shareholders to be well informed about the manner in which the company's mission will be achieved. This will also inform shareholders and potential stakeholders of whether the board is overcrowded and the manner in which the company has complied with the code of good governance, when it comes to the inclusion of outsiders (independent non-directors).

Disclosure of information regarding the second question tests the effectiveness of the board of directors. The more times they meet, the more ineffective strategies will be reviewed and correct decisions taken. Disclosure of information relating to the board committees' third question will assist in determining the board activities during the year. Using this information, company stakeholders will be able to perceive if the board of directors of a company attempted to fulfil their corporate governance requirements.

Other board committees consist amongst others, of the nomination committee, safety and sustainable development committee, finance committee, director affairs committee, credit committee, implementation committee, audit and corporate governance committee, employment equity and development committee, executive committee, investment committee, market development committee, political donations committee, assets and liability committee and the tender committee.

4.9 RISK MANAGEMENT AND INTERNAL CONTROLS

The Committee of Sponsoring Organisations of the Treadway Commission (COSO 2004), defines risk management and internal controls as follows: "risk management is a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives."

In their definition of risk, Kliem & Ludin (1997: 4) define risk as the occurrence of an event that has a consequence or an impact on a project. Knight (1999: 4) provides a broader view of risk by analysing the three elements of risk, these being: firstly, the perception that something could happen; secondly, the likelihood of something happening; and lastly the consequences of its happening.

From the above definitions, it is clear that risk is concerned with the potential opportunity or threat that may impact or disturb an organisation's ability to meet its objective. The Government of Ontario in Canada (2000: 1) confirms this by stating that risks encompasses all potential obstacles, consequences and opportunities impacting on the abilities of an enterprise to meet its objectives. Further to the above, the Government of Ontario in Canada (2000: 1) argues that risks of an organisation can be found internally and externally. Risk categories and areas are: environmental; operational; financial; strategic and informational.

In South Africa, the King II report (IOD 2002: 73) defines risk management using the following three definitions:

- The risk management process entails planning, arranging and controlling of activities and sources to minimise the impact of all risks on all levels of organisation;
- Risk management is thus a process that utilises the internal controls as one of the measures to mitigate and control risk. Risk, for example, political, technological and legislative risks that cannot be mitigated through the traditional internal controls

within a company should be dealt with using flexibility as well as forward planning and similar mechanisms; and

- Risk management can be defined as the identification and the evaluation of actual and potential risk areas as they pertain to the company as an entity, followed by a process of termination, transfer, tolerance and mitigation of each risk (IOD 2002).

The King II report (IOD 2002: 74) states that risk management should be practised throughout the company by all employees of the company in their day-to-day activities. According to the King II report (IOD 2002: 74) once risk management is preformed, all forms of risks can be easily identified and managed effectively in an integrated approach. COSO (2004: 3) argues that an integrated response to multiple risks is critically important due to the fact that in their analysis, all processes carry inherent risks; therefore organisational risk management should enable integrated solution for addressing these risks.

Kloman (1999: 1) substantiates the above discussion by using a piano player parable, where he says: “watch a piano player, its keys moving up and down with no visible evidence of control. Risks are like that, they don’t appear to be connected, but like piano keys controlled by an unseen paper roll, they produce music when coordinated, and a cacophony when not. Striking a single key produces a single note. Striking several keys blindly means dissonance. However, striking a group of keys in a coordinated manner produces a chord. This is the goal today of managing organisational risks, that is creating harmony other than atonality.” (Kloman 1999.)

According to COSO (2004: 3) risk management is related to corporate governance as it provides information about risks for the board of directors. From the above, it is clear that risk management is a continuous process that should be driven by the board of directors and can be used as a tool to verify the effectiveness of internal controls within a company. Risk management is not a once off thing, it has to be applied throughout the company in an attempt to understand and achieve the objectives, vision, mission and the company strategy (COSO 2004).

IFAC (2008: 355 in ISA 315: para. 42) defines internal control as a process that provides reasonable assurance regarding the achievement of objectives in the reliability of financial reporting, effectiveness and efficiency of operations as well as compliance with applicable laws and regulations.

The International Organisation of Supreme Audit Institutions (INTOSAI) (2005: 1), argues that internal controls assist in the provision of reasonable assurance that the organisation adheres to laws, regulations and management directions, promotes orderly, economical, efficient operations and achieves planned outcomes, safeguards shareholders' resources against fraud, waste, mismanagement and abuse, and provides quality products and services consistent with its mission and vision and develops and maintains reliable financial and management data and ensures that this data is fairly disclosed and timeously reported.

According to COSO (2004), internal controls refer to a process effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations;
- Reliability of financial reporting; and
- Compliance with laws and regulations (COSO 2004).

It follows that internal controls are designed and implemented to address identified risks that threaten the achievement of any of the company objectives. Reasonable controls mentioned above mean that internal controls do not provide absolute assurance about achieving these objectives (IFAC 2008: 361 in ISA 315: para. 64). The likelihood of achieving these objectives is affected by limitations inherent to internal controls. INTOSAI (2005: 12) observes the following issues as limitations inherent to internal controls:

- An effective system of internal control reduces the probability of not achieving the company's objectives. Based on this, there will always be a risk of internal control being poorly designed or failing to operate as intended;

- The design of the internal control system faces resource constraints. Employees should consider the benefits of internal controls in relation to their tasks. Maintaining an internal control system that eliminates risks of loss is not realistic and would probably cost more than is warranted by the benefit derived;
- Internal controls are subject to the human factors. Based on this, they are also subject to flaws in their design, errors of judgement or interpretation, misunderstanding, carelessness, fatigue, distraction, collusion, abuse and being overridden; and
- Organisational changes and management attitude can have a profound impact on the effectiveness of internal controls and the employees operating the system. Based on this, it is important that management of a company continuously review and update internal controls, thereby communicating changes to employees and setting a good example by adhering to the controls (INTOSAI 2005).

Hillison, Pacini and Sinason (1999: 354) argue that in assessment of internal controls, by either the internal or external auditors, the failure of controls could be detected due to:

- Lack of segregation of powers;
- Poor communication and poor discussion about rules and consequences of rules and laws about fraud and corruption;
- Lack of audit trail;
- Ineffective supervision;
- Lack of transaction authorisation;
- Poor accounting records, and
- Breakdown of procedures, i.e. unauthorised computer access (Hillison *et al* 1999).

According to Visser and Erasmus (2002: 294), the following are characteristics of an adequate internal control system:

- Timeliness – an internal control system should detect potential or actual deviations early enough, ensuring that management can take corrective actions timeously to limit unnecessary costs.

- Economy – although internal control systems should provide assurance that the objectives of an institution are achieved, this should also ensure minimum cost and as few undesirable side effects as possible.
- Accountability – an internal control system should ensure that employees are held accountable for their assigned responsibilities and tasks. This is achieved by applying the prescribed procedures.
- Flexibility – a changing work environment is inevitable, therefore internal controls should be flexible to accommodate such changes.
- Appropriateness – internal controls should be designed in the manner that they meet the needs of management. This will in turn allow management to achieve company objectives (Visser & Erasmus 2002).

Jensen (1993) argues that the board of directors is crucial to effective internal control systems. According to Jensen (1993: 862) problems with corporate internal control systems originate with the board of directors. The board sets the tone of an organisation and influences the control consciousness of employees. It also forms the foundation for effective internal controls thereby providing discipline and structure (IFAC 2008: 362 in ISA 315 para. 67). The ultimate consequence of a dysfunctional corporate internal control system is the failure of the firm.

The concepts of corporate governance heavily rely on the requisites of risk management and internal controls. Internal controls help ensure that processes operate as designed and that risk responses (risk treatments) in risk management are carried out. Similar to Jensen (1993), the King II report (IOD 2002) argues that the total process of risk management remains the duty of the board of directors.

Though the designation, implementation and monitoring of risk in a company is the duty of management, management is in turn accountable to the board of directors. Risk management information needs to be assessed on an ongoing basis, control activities should be designed to respond to risk throughout the company and all the information has to be disclosed in the annual report of a company (Naidoo 2002 & IOD 2002).

From the above discussion of risk management and internal controls, it is apparent that risk management and internal controls play an important role in maintaining the effectiveness and efficiency of operations, ensuring reliable financial reporting, compliance with laws and regulations and prevention and detection of fraud. For this reason, the information relating to risk management and internal controls is crucial. Section 404 of the Sarbanes-Oxley Act, 2002, for example, requires companies perform a fraud risk assessment and assess related controls. This typically involves identifying scenarios in which theft or loss could occur and determining if existing control procedures are effectively managed and whether risk is mitigated to an acceptable level.

The Corporate Laws Amendment Act, 2006 (RSA 2006) is silent on the treatment of risk management and internal controls. The King II report (IOD 2002) requires the board to be responsible for the total process of risk management, whilst management remains accountable to the board for designing, implementing and monitoring the process of risk management and integrating it into its day-to-day activities. The board must decide the company's risk appetite and tolerance. They should also set the risk strategy in liaison with executive directors and senior managers. Risk policies should be clearly communicated to all employees to ensure that the risk strategy is incorporated into the language and the culture of a company (IOD 2002).

The King II report (IOD 2002) further requires the board to ensure that the assessment of the processes and outcomes of key risks is undertaken annually and that important risk management information is disclosed annually in the company's annual report or to shareholders at the AGM. Risks should be assessed on an ongoing basis and control activities should be designed to respond to risks throughout the company (IOD 2002).

4.10 CHECKLIST QUESTIONS ON INTERNAL CONTROLS AND RISK MANAGEMENT

In order to check the ability of the JSE's top-40 selected companies to comply with the corporate governance disclosure requirements in annual reports, in terms of the risk management and internal controls, the questions set out below have been used (refer to Appendix A (2)):

- Does the annual report of a company contain the most important risk management information i.e. the headline risk areas and the mitigating strategies?
- Does the annual report contain the statement of internal controls issued by the directors and endorsed by the board of directors?

Disclosure of this information in the annual report of a company will confirm management's concerns and their commitment to the identification of the most important risks that a company faces and confirm the development of risk mitigation strategies to minimise threats to shareholders' capital.

4.11 INTERNAL AUDIT

The Institute of Internal Auditors (IIA) (2004) defines internal auditing as "an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations". The IIA (2004) further states that internal auditing assists an organisation to accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control, and governance processes. Internal auditing plays a critical role in monitoring and evaluation of the effectiveness of the organisation's risk management processes (IIA 2004).

Chun (1997: 247) regards internal auditing as an integrated part of the process of accountability. Its objective is to ensure and promote the effective performance of accountability assumed by the management of a company. Three conditions are necessary for attaining the objectives of internal audit, these being independence, organisational status and objectivity (Chun 1997: 247).

Visser and Erasmus (2002: 330) describe internal audit as an independent appraisal function within an organisation for the review of activities as a service to all levels of management. Internal audit therefore is a control which measures, evaluates and reports upon the effectiveness of internal controls (Visser & Erasmus 2002).

Visser and Erasmus (2002: 330) agree that the responsibilities of internal audit should be to identify, review, appraise and report on the following issues:

- The soundness, adequacy and application of internal controls;
- The extent to which the company's assets and interest are accounted for and safeguarded from losses of all kinds arising from waste, fraud and mal-administration; and
- The suitability and the reliability of financial and other management information generated within the institution (Visser & Erasmus 2002).

IFAC (2008: 552 in ISA 315 para. 5) concurs with Visser and Erasmus (2002) by stating that the scope and objectives of internal auditing vary widely and depend on the size and structure of the entity and the requirements of management. According to IFAC (2008) internal auditing activities include one or more of the following:

- Monitoring of internal control — the establishment of adequate internal control is a responsibility of management which demands proper attention on a continuous basis. Internal auditing is ordinarily assigned specific responsibility by management for reviewing controls, monitoring their operation and recommending improvements thereto;

- Examination of financial and operating information — this may include review of the means used to identify, measure, classify and report such information and specific inquiry into individual items including detailed testing of transactions, balances and procedures;
- Review of the economy, efficiency and effectiveness of operations including non-financial controls of an entity; and
- Review of compliance with laws, regulations and other external requirements and with management policies and directives and other internal requirements (IFAC 2008: 552 in ISA 315 para. 5).

Principle 3 of the Basel Committee on Banking Supervision (2000: 3) also regards the internal audit function as part of the ongoing monitoring of the system of internal controls and furthermore as an integral part of the company (or bank's) internal capital assessment procedure, because it provides an independent assessment of the adequacy of, and compliance with, the company (or bank's) established policies and procedures. As such, the internal audit function assists members of the organisation in the effective discharge of their responsibilities (Basel Committee on Banking Supervision 2000).

In discharging its duties, the Basel Committee on Banking Supervision (2000: 3) requires the internal audit function within the banking (company) environment to perform the following: the examination and evaluation of the adequacy and effectiveness of internal control systems; the review of the application and effectiveness of risk management procedures and risk assessment methodologies; the review of the management and financial information systems, including the electronic information system and electronic banking services; the review of the accuracy and reliability of accounting records and financial reports; the review of the bank's (company's) system of assessing its capital in relation to its estimate of risk; the testing of both transactions and the functioning of specific internal control procedures; the adherence to legal and regulatory requirements, codes of conduct, the implementation of policies and procedures; the testing of the integrity, reliability and timeliness of regulatory reporting and the carrying out of special investigations (Basel Committee on Banking Supervision 2000).

The IIA (2004) regards risk management as a fundamental element of corporate governance. According to the IIA (2004), management is responsible for establishing and operating the risk management framework on behalf of the board. Internal audit's core role in relation to risk management is to provide assurance to management and to the board on the effectiveness of risk management strategies. When the internal audit function decides to extend its activities beyond this core role, it should apply certain safeguards, including treating the engagements as consulting services and, therefore, applying all relevant standards. In this way, the internal audit function protects its independence and the objectivity of its assurance services (IIA 2004).

One of the key focus areas of internal auditing, as it relates to corporate governance, is assisting the audit committee of the board of directors to perform its responsibilities effectively. This may include reporting critical internal control problems, informing the audit committee privately on the capabilities of key managers, suggesting questions or topics for the audit committee's meeting agendas and coordinating carefully with the external auditor and management to ensure the committee receives effective information (IOD 2002).

The Basel Committee on Banking Supervision (2000: 2 para. 7) stresses the need for objectivity and impartiality of the internal audit department within the banking industry. According to the Basel Committee on Banking Supervision (2000: 2) internal audit objectivity and impartiality does not necessarily exclude the possibility that the internal audit department is involved in advising or consulting. The Basel Committee on Banking Supervision (2000: 2) argues that advising senior management on the development of internal controls by the internal audit function, for example, is often a cost-effective way of ensuring that management makes an informed decision when controls need to be introduced. However, other forms of advising or consulting should be ancillary to the basic function of internal audit, which is an independent appraisal function established within the bank (company) to examine and evaluate its internal control systems, including controls over financial reporting (The Basel Committee on Banking Supervision 2000).

More than 40 years ago, Normanton (1966: 113) constructed a clear comparison between internal auditors and external auditors to avoid confusion, as well as to highlight the overlapping activities of these two types of auditors. Recently, Sawyer, Dittenhofer and Scheiner (2003) and IFAC (2008: 552 in ISA 610 paras. 6, 7 & 8) provided a definition of the differences between these two auditors. The differences highlighted by Normanton (1966), IFAC (2008) and Sawyer *et al* (2003) are outlined in Table 4.3 below:

TABLE 4.3 – DINSTINCTION BETWEEN INTERNAL AND EXTERNAL AUDITORS

INTERNAL AUDIT	EXTERNAL AUDIT	INTERNAL AUDIT	EXTERNAL AUDIT
Source: Normanton (1966: 113)		Source: IFAC (2008: 552) and Sawyer *et al* (2003)	
• Fraud detection.	• Determine if expenditure exceeded the appropriation limit.	• According to IFAC (2008: 552) the role of internal auditing is determined by management, and its objectives differ from those of the external auditor who is appointed to report independently on the financial statements. The internal audit function's objectives vary according to management's requirements. • Sawyer *et al* (2003) concur with the above by stating that internal auditors generally consider operations as a whole with respect to the five key internal control objectives, not just the financial aspects.	• According to IFAC (2008: 552) the external auditor's primary concern is whether the financial statements are free of material misstatements. • Sawyer *et al* (2003) support the above by stating that external auditors focus primarily on financial control systems that have a direct, significant effect on the figures reported in financial statements.
• Procedural inconsistencies.	• Assure compliance with legislative intent.		
• Provide means to recommend final control and agency procedures to management of a company.	• Ensure compliance with acceptable administrative and accounting practices and procedures.		

• Provide thorough audit of accepted standards.	• Assess efficiency of the operation and determine programme effectiveness.	• According to IFAC (2008: 552) internal auditing is part of the entity. Irrespective of the degree of autonomy and objectivity of internal auditing, it cannot achieve the same degree of independence as required of the external auditor when expressing an opinion on the financial statements. • Sawyer *et al* (2003) argue that internal auditors are generally concerned with even small incidents of fraud, waste, and abuse as symptoms of underlying operational issues.	• According to IFAC (2008: 552) the external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by any use made of internal auditing. All judgments relating to the audit of the financial statements are those of the external auditor. • For Sawyer *et al* (2003) the external auditor may not be concerned if the incidents do not materially affect the financial statements which are reasonable, given the fact that external auditors are engaged to form an opinion only of the organisation's financial statements.
• Internal control.	• Legality of expenditure.		

According to the IIA (2004: 1), there are activities of which internal auditors should not involve themselves with in a company. However, there are various legitimate internal auditing roles which contribute to safeguard a company. Table 4.4 outlines these activities and roles of internal audit.

TABLE 4.4 – ACTIVITIES AND LEGITIMATE INTERNAL AUDIT ROLES

UNACCEPTABLE ACTIVITIES	LEGITIMATE INTERNAL AUDIT ACTIVITIES
Source: IIA (2004: 1)	
• Setting the risk appetite.	• Facilitating, identification and evaluation of risks.
• Imposing risk management processes.	• Coaching management in responding to risks.
• Managing assurance on risks.	• Coordinating enterprise-wide risk management (ERM) activities.
• Making decisions on risk responses.	• Has the full cooperation of the board and management.
• Implementing risk responses on management's behalf.	• Consolidating the reporting on risks.
• Accountability for risk management	• Maintaining and developing the risk management framework.
	• Championing the establishment of ERM.
	• Developing risk management strategy for board approval

The King II report (IOD 2002) recommends that each company needs to have an effective internal audit. An effective internal audit is one that:

- Has the full cooperation of the board and management;
- Has a clearly defined role;
- Reports directly to audit committee meetings;
- Has unrestricted access to the chairman of the company and the audit committee; and
- Is independent (Naidoo 2002 & IOD 2002).

From the above, it is apparent that one of the basic functions of internal audit is independent appraisal of the company's internal controls and reviewing activities to ensure that they are carried out as originally intended. The Corporate Laws Amendment Act, 2006 (RSA 2006) does not make adequate assertions on the matters relating to the internal audit function, with the exception of section 270A which states that the audit committee of a widely held company must receive and deal appropriately with any complaints (whether from inside the company or outside the company) relating to internal audit (RSA 2006: sec. 26 (sec. 270A (1) (g))).

4.12 CHECKLIST QUESTIONS ON INTERNAL AUDIT

To check the ability of a company to mitigate its risks by implementing strict internal control and its ability to report on this control, in its annual report, thus discharging its duties effectively and complying with corporate governance requirements according to the King II report (IOD 2002), the following questions with regard to the disclosure of internal audit information in the annual report of a company have been used to check if the top-40 JSE selected companies comply (refer to Appendix A (3)).

- Does the information regarding the independence and objectivity of the internal audit function appear in the annual report of a company?
- Does the annual report capture the information regarding the relationship between the risk management unit and internal audit unit?

The above questions seek to validate if internal audit within a company is independent and objective. For the internal audit function to be independent and objective, IIA (2004) requires that the internal audit activity:

- Be independent when performing its duties (IIA 2004: standard 1100).
- Be free from interference in determining the scope of internal auditing, performing work, and communicating results (IIA 2004: standard 1110. A1).
- Refrain from assessing specific operations for which it was previously responsible (IIA 2004: standard 1130. A1).
- Give assurance engagements for functions over which the chief audit executive has responsibility, this should be overseen by a party outside the internal audit activity (IIA 2004: standard 1130.A2).

From the above discussion, it is apparent that information relating to the internal audit function is of outmost importance because it has a role to play in internal controls of a company, risk management and corporate governance. The IIA (2004) agrees with the above statement in its description of internal audit as "one of the cornerstones of corporate governance, along with the board of directors, senior management, and external auditing. Because of the internal auditors' unique position within the organization, they provide audit committee members with valuable assistance by giving objective assurance on governance, risk management, and control processes". The following are some of the roles played by the internal audit function in risk management and corporate governance in a company:

- Giving assurance on risk management processes.
- Giving assurance that risks are correctly evaluated.
- Evaluating risk management processes.
- Evaluating the reporting of key risks.
- Reviewing the management of key risks (IIA 2004).

With regard to internal control systems, internal audit's role of internal auditing activity is primarily directed at improving control within the company. COSO (2004) argues that internal audit assists in the achievement of internal control systems within an organisation.

4.13 INTEGRATED SUSTAINABILITY REPORTING

There has been a growing interest in the disclosure of the social and environmental information in the annual reports. According to Dierkes and Antal (1985) research indicates that stakeholders want to see an increase in corporate environmental disclosures in the annual reports of companies. Rankin (1996) agrees with the above, in her survey which found that 68% of stakeholders sought environmental information from the annual report in the first instance while 43% sought this information from other sources.

Milne and Adler (1999) sought to understand the reason why companies disclose environmental information in their annual reports. Their study concludes that companies disclose environmental information for publicity purposes. They argued that the annual report has now become a public relations document and is used by management to portray a positive image of a company's social and environmental performance (Milne & Adler 1999).

Ingram and Frazier (1980: 614) view the lack of external monitoring as a cause of weak social and environmental disclosures in annual reports. According to them there is very little effort made to monitor firms' social activities or to validate their disclosures, and the management of a company uses its own discretion to decide which information to disclose or not. This concurs with an argument put forward by Milne and Adler (1999) above, that annual reports are now a public relations document aimed at portraying a positive public image of a company's environmental and social performance.

The point articulated by Ingram and Frazier (1980) that little effort is made to monitor a firm's social and environmental disclosures is also confirmed by Aupperle, Carroll and Hartfield (1985). In their examination of the relationship between corporate social responsibility and profitability, they (Aupperle *et al* 1985: 446) argued that an enormous body of literature has recently emerged concerning corporate social responsibility. However, they pointed out that actual empirical research is lacking.

The Global Reporting Initiative (GRI) was founded because of the absence of integrated sustainability reporting guidelines. The GRI's duty is to produce the world's standard in sustainability reporting guidelines. The GRI (2008) defines sustainability reporting as "the action where a company publicly communicates their economic, environmental, and social performance". Its mission is "to make sustainability reporting by all companies as routine and comparable as financial reporting". The GRI Guidelines are the most common framework used in the world for reporting and its framework guides companies with regard to the information that should be disclosed in their sustainability reports. (GRI 2008.)

The first GRI sustainability reporting guidelines were released in the year 2000. During this period, there was a world-wide outreach effort to communicate the arrival of the GRI sustainability reporting guidelines. Events were held in South America, North America, Australia, Europe, South Asia, and Japan. Based on these efforts, by the end of the financial year 2000, there were 50 companies who released their sustainability reports based on the GRI guidelines. This number increased to 80 companies in 2001**.** The second generation of sustainability reporting guidelines were released in Johannesburg, South Africa, at the World Summit for Sustainable Development in 2002. During this period, there were 150 companies who released sustainability reports based on the GRI guidelines. (GRI 2008.)

The recent generation of sustainability reporting guidelines were released in 2006. These guidelines are known as the third generation of sustainability reporting guidelines. Some of the reasons for updating the GRI reporting guidelines included amongst others:

- A growth in the expertise available in the field compared to when the 2002 guidelines were finalised;
- A more informed company stakeholder base, who now know what they want to see included in the guidelines and reports; and
- The GRI’s performance enhancement by improving its guidance to industry through structured feedback processes from guideline users (GRI 2008).

In its survey on sustainability reporting, KPMG (2006: 24) reveals that South African sustainability reports are compliant with the GRI guidelines and are becoming more sophisticated as comparable data is made available and assessed in meaningful ways. However, Hackston and Milne (1996) argue that this may be caused by the fact that those companies, whose economic activities directly modify, for example the environment, are more likely to disclose the information about their environmental impacts than companies in other industries.

According to KPMG (2006), comparable year-on-year data disclosed in annual reports reflects a rising trend. KPMG (2006) further argues that the ability to compare data provides a company with valuable information on internal performance improvements and challenges if the data is progressively used to determine relationships between issues and impacts and in this way response measures can be appropriately applied. The value of the data is that it can act as substantial evidence to justify innovative initiatives that make both sustainability sense and business sense (KPMG 2006).

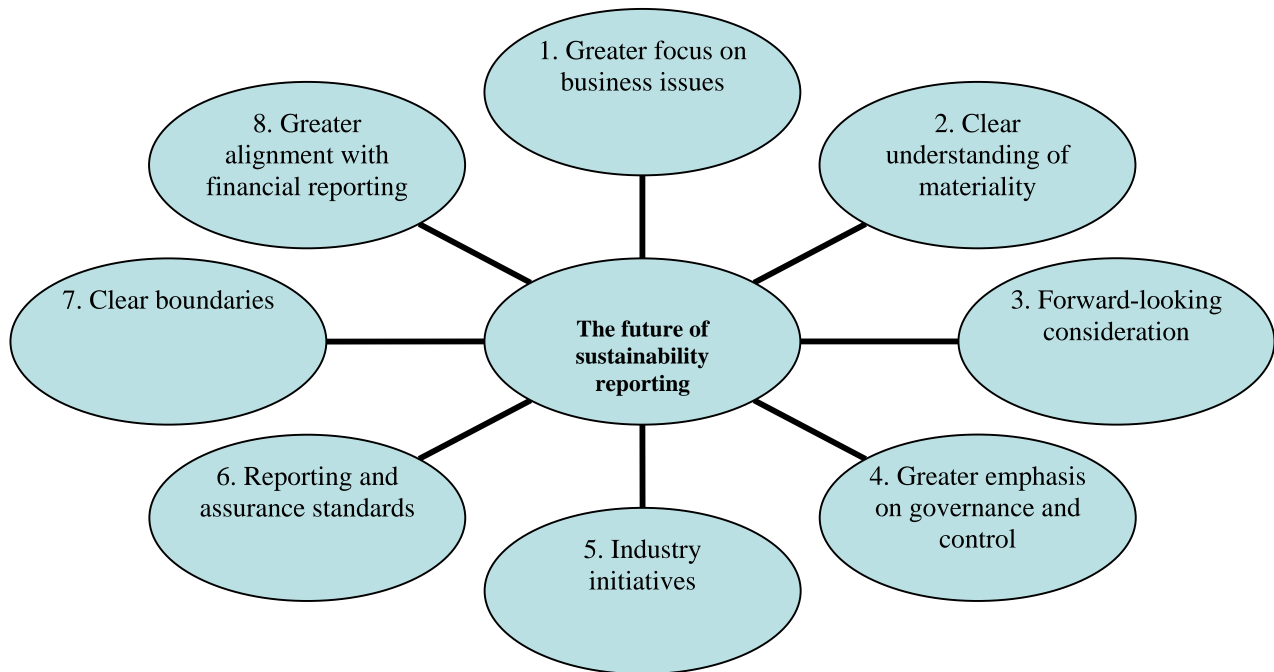
Another survey on sustainable development undertaken by the Business Report (2007a) reveals that for different reasons, ten of then identified JSE's top-40 listed companies did not participate in South Africa's first attempt to collate business’ response to climate change. The Business Report argues that administrative problems appear to account for some of the failure of these companies to participate in the study. According to the survey

though, a worrying absence of accountability appears to be one of the factors that contributed to non-response (Business Report 2007a).

A recent study by Bench Marks Foundation (2008) concurs with the Business Report survey (2007a). According to Bench Marks Foundation "the concept of corporate social responsibility (CSR) in many mining companies is just a pipe dream". The main concern of this study is that many mining operations across South Africa operate without water-use licences, causing clashes between communities and farmers on the one hand and mining corporations on the other (Bench Marks Foundation 2008). This confirms what the Business Report (2007a) termed the "accountability problem" above.

Even though problems such as those outlined above persist in South Africa, KPMG (2006) argues that the future of sustainability reporting in South Africa is bright. To substantiate this, they cite the GRI website which ranked South Africa tenth among the 58 countries with respect to applying the GRI Guidelines as a framework for reporting. To support the above, KPMG (2006: 28) predicts the future of sustainability reporting using diagram 4.1 below:

FIGURE 4.1 – THE FUTURE OF SUSTAINABILITY REPORTING



Source: KPMG (2006: 28)

The above diagram is explained by KPMG (2006: 28) as follows:

- Greater focus on business issues – in future there will be a move from information overload to focused reporting, that is precise information of better quality.
- Clear understanding of materiality – companies will start to report on what really is important.
- Forward-looking consideration – companies will start to deal with new and emerging issues not just to be reactive.
- Greater emphasis on governance and control – stakeholders' trust will be built on a description of how a business manages and controls its risks.

- Industry initiatives – new initiatives such as the International Council on Mining and Metals (ICMM) in the mining industry, the cement sustainability initiative and the banking sector equator.
- Reporting and assurance standards – greater consistency in reporting and assurance through standards such as the GRI.
- Clear boundaries – clear definition of operating boundaries.
- Greater alignment with financial reporting – shareholders need to consider the overall performance of a company, not just financial information (KPMG 2006).

According to the King II report (IOD 2002), companies are required to report annually on the nature and the extent of their social, transformation, ethical, safety, health and environmental management policies and practices (Naidoo 2002 & IOD 2002). Matters of importance that should be disclosed in the annual reports of a company include among others things, health and safety issues, the impact of HIV/AIDS and the company's strategy to minimise the effects of the epidemic, environmental reporting, social investment spending, employment equity, human capital development issues as well as black economic empowerment. It is important to note that the Corporate Laws Amendment Act, 2006 (RSA 2006) does not address sustainability reporting.

4.14 CHECKLIST QUESTIONS ON INTEGRATED SUSTAINABILITY REPORTING

To determine companies' ability to discharge their duties effectively and their compliance with corporate governance requirements according to the King II report (IOD 2002), the following questions with regard to the disclosure of integrated sustainability reporting information in annual reports has been used to check if the top-40 JSE selected companies comply (refer to Appendix A (4)):

- Does the annual report of a company contain information regarding health and safety issues?
- Does the annual report of a company contain information regarding environmental reporting?

- Does the annual report of a company contain information regarding social investment spending?
- Does the annual report of a company contain information regarding employment equity?
- Does the annual report of a company contain information regarding human capital development?
- Does the annual report of a company contain information regarding black economic empowerment?

The above questions seek to determine the extent of the information disclosed in the annual report of a company with regard to integrated sustainability reporting. Communities, for example, will be informed of a company's view on maintenance of the environment it operates in, while potential employees by reading through the annual report can decide if the company invests in human capital or not. On the other hand, the government will be in a position to obtain information on preventative HIV/AIDS initiatives implemented by a company as well as BEE strategies implemented.

4.15 ACCOUNTING AND AUDITING

4.15.1 Accounting practices and reporting

According to Lee Jr and Johnson (1998: 309) accounting is an art of analysing, recording evaluating, interpreting and summarising organisational financial activities and status and communicating the results thereof. Accounting information contains mostly financial information on the receipt of funds as well as spending of those funds (Lee Jr & Johnson 1998). According to Siswana (2007: 252) the above view suggests that for accounting to be effective, financial information with proper financial systems and effective record management is crucial as data mostly reflects the financial position and performance of an enterprise (Siswana 2007).

The financial position and performance of an enterprise referred to above by Siswana (2007) is described by IFAC (2008: 121 in ethics) and IASB (2007: framework para. 7) as the financial statements which should consist of the balance sheet, income statement or profit and loss accounts, statement of changes in financial position (which may be presented in a variety of ways, for example, as a statement of cash flows or a statement of fund flows), notes and other statements and explanatory materials which are identified as being part of the financial statements (IFAC 2008 & IASB 2007).

According to SAICA (2007/2008: 7 para. 33 in ISA 200) the responsibility of preparing financial statements in accordance with the applicable financial reporting framework remains the duty of management of a company. The Corporate Laws Amendment Act, 2006 (RSA 2006: sec 36 (sec. 285A)) concurs with SAICA (2007/2008) by stating that a company must prepare financial statements that fairly present the financial position and the results of operations of the company (and its subsidiaries, if applicable). The Corporate Laws Amendment Act, 2006 (RSA 2006) further requires the management of a company to state in the financial statements that the company has complied with the Corporate Laws Amendment Act, 2006 (RSA 2006) as well as financial reporting standards (RSA 2006: sec. 36 (sec. 285A (3) (a) & (b))).

Section 287A of the Act (RSA 2006: sec. 39 (sec. 287A (1))) warns directors and management that if any financial report of a company is false or misleading in a material respect, any person who is a party to the preparation, approval, publication, issue or supply of that report, and who knows about the irregularities, is guilty of contravening the Corporate Laws Amendment Act, 2006 (RSA 2006). To comply with the Corporate Laws Amendment Act, 2006 (RSA 2006), management and directors of a company should prepare financial statements that satisfy the qualitative characteristics. According to the IASB framework (2007: framework para. 24), qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability. The qualitative characteristics were discussed in detail in paragraph 4.2.3 of this Chapter.

The European Federation of Accountants (2002: 1) agrees with the above by stating that financial statements presenting a true and fair view of a company's financial position are one of the cornerstones of any capital market. The unexpected collapse of an important company listed on a stock exchange risks undermining the credibility of the information and the regulatory system which is put in place to protect investors. Even if business failures are unavoidable, this raises the question as to whether the financial statements concerned were sufficiently transparent in disclosing the risks run by investors. When the market considers that the information was not appropriate although a clean opinion was provided in the audit report, the position of auditors is usually questioned (European Federation of Accountants 2002).

According to IASB (2007: framework para. 12), the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. However, paragraph 13 of the framework warns that financial statements prepared for the above purpose do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information (IASB 2007: framework para. 13).

To satisfy the needs of the users for economic decision making, the OECD (2004: 22) argues that the disclosure of information in the annual report should include, but not be limited to, material information on the financial and operating results of the company, company objectives, major share ownership and voting rights, remuneration policy for members of the board and key executives, and information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board, related party transactions, foreseeable risk factors, issues regarding employees and other stakeholders, governance structures and policies, in particular, the content of any corporate governance code or policy and the process by which it is implemented (OECD 2004).

The OECD (2004: 22) further argues that financial statements should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure. Further to the above, an annual audit should be conducted by an independent, competent and qualified auditor in order to provide external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects. It is also worth noting that external auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit (OECD 2004).

In the following discussion, reference will particularly be made to the corporate governance reforms that have been implemented as a result of the East Asian crisis which led to the collapse of Asian economies. Countries that were affected by the crisis are Indonesia, Korea, Thailand and Malaysia.

According to Woo-Nam and Nam (2004), before the East Asian crisis, information disclosure (as described above) was deemed to be incomplete and seriously flawed. Woo-Nam and Nam (2004) acknowledge that before 1997, these countries had laws that required corporations to publish audited annual reports shortly after the end of the business year. Listed companies were required to publish their audited annual reports within three months of the end of the business year in Indonesia, 90 days in Korea, 110 days in Thailand, and four months in Malaysia. In Thailand, financial statements were to be publicly available within 60 days of the end of the business year. All four these countries began requiring more frequent disclosure following the financial crisis. For example, companies in these countries are now required to submit quarterly financial reports and immediate reporting of information that might influence stock prices (Woo-Nam & Nam 2004).

After recovering from the crisis, these countries introduced a wide range of reform measures to improve information disclosed to shareholders and to the general public. According to Allen and Gale (2001), Malaysia, for example, has been engaging in efforts aimed at improving disclosure. Further to the above, reform measures adopted by the

East Asian countries since the economic crisis encompass the auditing process, the timing of disclosure, and the types of information that must be disclosed (Woo-Nam & Nam 2004).

4.15.2 External and internal auditing

Thailand, Indonesia and Korea introduced reform measures aimed at ensuring more effective auditing of reports submitted by companies and they made audit committees mandatory. Woo-Nam and Nam (2004) further note that Korea and Malaysia are introducing measures that require listed companies' audit committees to include an expert on finance or accounting.

In South Africa, the King II report (IOD 2002) states that companies should aim for efficient audit processes using external auditors in combination with internal auditors. Further to this, the audit committee of the board should consider whether or not an interim report should be subject to independent external audit review. The King II report (IOD 2002) suggests that at the interim stage, a company should review its previous assessment of itself as a going concern (IOD 2002).

In Korea and Malaysia, auditors and companies that violate laws and regulations on auditing and information disclosure can face suspension of auditing licenses and delisting, in addition to fines and warnings. For instance, a number of auditing firms were closed in Korea after they were found to have been responsible for the improper auditing of some of the chaebols (large family-owned conglomerates in Korea) that had encountered serious financial difficulties. As a consequence, Korean auditing firms now have a greater incentive to perform their jobs more rigorously, but penalties for violations are still regarded as weaker than those in Indonesia and Thailand (Woo-Nam & Nam 2004).

Facts that were previously taken for granted prior to the crisis need to now be disclosed in annual reports. According to Allen and Gale (2001), East Asian companies are required to disclose information such as corporate governance structure and practices, education and professional experience of directors and key executives, remuneration of directors

and key executives in annual reports. Deviations from the above corporate governance codes, and forward-looking statements (i.e. going concern) by companies are punishable offences (Allen & Gale 2001).

The above discussion suggests that the disclosure of information that satisfies the qualitative characteristics for annual financial statements is one of the important elements of corporate governance. Equally important is the role of auditors in the corporate governance process as they give credibility by verifying the information reported by management in the annual report. Wiseman (1982), Barlett and Chandler (1997), Savage (1998), Thomas and Kenny (1996), Wilmshurst and Frost (2000) and Savage and Cataldo (1999) all find that the annual report is an important document for effective communication with company stakeholders and the information reported therein should therefore be credible. Emery *et al* (2004) goes a step further by suggesting that the audited annual report is a potentially cost effective monitoring device for reducing agency costs, because financial statements serve as an early warning and a monitoring device for agency relationships.

The use of both internal and external auditors increases the effectiveness of audits as the two types have different strengths. The IIA (2004: 3), for example, argues that internal auditors spend most or all of their time working in the same company and as a result, they have a better understanding of the culture and the workings of the company. This allows internal auditors to see things that external auditors would not see during their visits (IIA 2004: 3). However, the IIA (2004: 4) acknowledges that external auditors work for multiple clients and as a result of this, they are exposed to a wider variety of financial issues, therefore, external auditors are more likely to discover and solve issues that internal auditors have not dealt with before.

In addition to improving effectiveness, the IIA (2004: 4) argues that coordination increases efficiency. When the audit is not properly coordinated, external auditors may duplicate work already performed by internal auditors. This redundancy causes higher audit fees but does not increase the effectiveness of the audit. Similarly, internal auditors

may duplicate external auditors' work, which results in wasted internal audit time (IIA 2004: 4).

From the above discussion, it is apparent that the relationship between internal and external auditors is of importance for the efficiency and effectiveness of audits within a company. Table 4.3 in section 4.11 outlined the relationship between internal and external auditors based on IFAC (2008 in ISA 610). This relationship is re-emphasised below as follows:

- The role of internal auditing is determined by management, and its objectives differ from those of the external auditor who is appointed to report independently on the financial statements. The internal audit function's objectives vary according to management's requirements. The external auditor's primary concern is whether financial statements are free of material misstatements. Nevertheless some of the means of achieving their respective objectives are often similar and thus certain aspects of internal auditing may be useful in determining the nature, timing and extent of external audit procedures.
- Internal auditing is part of the entity. Irrespective of the degree of autonomy and objectivity of internal auditing, it cannot achieve the same degree of independence as required of the external auditor when expressing an opinion on financial statements. The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the involvement of internal auditing. All judgments relating to the audit of financial statements are those of the external auditor. (IFAC 2008 in ISA 610.)

The auditor's opinion is expressed in the audit report which is included in the annual report/annual financial statements. The audit report referred above is defined by BNET (2008) as "the summary submission made by auditors of the findings of an audit. An audit report is usually of the financial records and accounts of a company".

IFAC (2008: 639 para. 20 in IAPS 1004) states that while the external auditor has the sole responsibility for the audit report and for determining the nature, timing and extent of audit procedures, much of the work of internal auditing can be useful to the external auditor in the auditing of financial statements. The auditor, therefore, as part of the audit, assesses the internal audit function insofar as the auditor believes that it will be relevant in determining the nature, timing and extent of the audit procedures (IFAC 2008: 639 para. 20 in IAPS 1004).

In forming an opinion on the financial statements, IFAC (2008: 640 para. 24 in IAPS 1004) requires the external auditor to carry out procedures designed to obtain reasonable assurance that the financial statements are prepared in all material respects in accordance with the applicable financial reporting framework. IFAC (2008: 641 para. 24 in IAPS 1004) warns that an audit does not guarantee all material misstatements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.

The importance of the audit report is also outlined by the Credit Research Foundation (1999). According to them, the contribution of the independent auditor is to give credibility to financial statements. Credibility, at this usage, means that "the financial statements can be believed; that is, they can be relied upon by outsiders, such as trade creditors, bankers, stockholders, government and other interested third parties" (Credit Research Foundation 1999).

The Credit Research Foundation (1999) further states that audited financial statements have become the accepted means by which business corporations report their operating results and financial position. The word "audit" when applied to financial statements means that the balance sheet, statements of income and retained earnings, and the statement of cash flows are accompanied by an audit report prepared by independent auditors, expressing their professional opinion as to the fairness of the company's

financial statements. The goal is to determine whether these statements have been prepared in conformity with GAAP (Credit Research Foundation 1999).

Due to the importance of the annual report, in its capacity as a tool for communicating inside information to outsiders and its credibility when audited, it is clear that the role played by external auditors is of crucial importance. The manner in which external auditors are selected has been strengthened by the Corporate Laws Amendment Act, 2006 (RSA 2006). The Corporate Laws Amendment Act, 2006 requires companies which offer shares for sale to the public (including, but not limited to, publicly-listed companies) to appoint audit committees. The audit committee must consist of at least two members, both of whom must be independent non-executive directors (RSA 2006: sec. 24 (sec. 269A (1), (3) & (4))).

The functions of the audit committee include the duty to nominate an auditor for appointment by the board, to fix the terms of his/her engagement and to determine which non-audit services the auditor may provide to the company. (RSA 2006: sec. 26 (sec. 270A (1) (a), (b) & (c))). The audit committee is also required to report its satisfaction on the independence of the auditor and deal with complaints in respect of the accounting practices and internal audit of the company or the auditing of its financial statements. (RSA 2006: sec. 26 (sec. 270A (1) (f) (ii) & (1) (g))).

Section 300A (1) of the Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 45 (sec. 300A (1))) requires that the designated auditor meet with the audit committee of a widely held company not more than one month before the board meets to approve the financial statements of the company for any financial year, so as to consider matters which appear to the auditor or the audit committee to be of importance and relevance to the proposed financial statements and to the general affairs of the company. According to section 300A (3) (RSA 2006: sec. 45 (sec. 300A (3)), should the designated auditor fail to attend a meeting as required by subsection (1), the auditor is guilty of an offence unless:

- He/she is prevented by circumstances beyond his/her control from attending the meeting (RSA 2006: sec. 45 (sec. 300A (3) (a))).

- The designated auditor arranges for another auditor with knowledge of the audit to attend and carry out the duties of the designated auditor at the meeting (RSA 2006: sec. 45 (sec. 300A (3) (b))).
- The designated auditor is a member of a firm and the individual attending the meeting in place of the designated auditor is a member of that firm (RSA 2006: sec. 45 (sec. 300A (3) (c))).

From the above discussion, it is apparent that the accuracy of accounting and auditing information disclosed in annual reports is of crucial importance. For an efficient audit process, the IOD (2002) suggests that companies should use the combination of both the internal audit and the external audit and these two functions should be independent of any interference.

4.16 CHECKLIST QUESTIONS ON ACCOUNTING AND AUDITING

To determine the company's ability to discharge its duties effectively and its compliance with corporate governance requirements according to the King II report (IOD 2002), the following questions with regards to the disclosure of the accounting and auditing information on the annual report of a company have been used to check if the top-40 JSE selected companies comply (refer to Appendix A (5)):

- Does the annual report reflect information relating to the relationship between the internal and external auditors?
- Does the annual report reflect information relating to the manner in which the external auditor was selected?
- Does the annual report contain the audit report with audit opinion (i.e. proof of audit report part of the annual report)?

The above questions seek to determine if there is interaction between the internal auditors and the external auditors. Disclosure of this information in the annual report means that there is cooperation between these two sets of bodies within a company and internal audit will not hide any information from the external auditors. This will enhance the credibility

of the annual report in a company by eliminating duplications in the work of internal and external auditors, while increasing efficiency and effectiveness. The manner in which the external auditor is selected will strengthen audit independence and the inclusion of the audit report strengthens information credibility for users. It is a statutory duty of an auditor (RSA 1973: sec. 301) to report to the shareholders of a company that the annual financial statement of that company was examined and whether they fairly present the financial position of the company and results of its operations in a manner required by the Act. The disclosure of information relating to the audit report determines whether financial statements have been prepared in conformity with the applicable financial reporting framework or not, and will further in turn determine the fairness of financial statements as expressed by the professional opinion of an independent auditor.

4.17 RELATION AND COMMUNICATIONS WITH COMPANY SHAREHOLDERS

The King II report (IOD 2002) requires companies to encourage more active participation by shareholders in its affairs and that companies be prepared to engage institutional investors in discussion of relevant issues. Further to the above, King II report (IOD 2002) requires companies to encourage shareholders to attend all relevant company meetings.

The board is further required by the King II report (IOD 2002) to present a balanced and understandable assessment of the company's position when reporting to company stakeholders. These reports should be made in the context of the need for greater transparency and accountability, and should be comprehensive and objective and where appropriate, reports should urge institutional shareholders in particular to play a more active role in ensuring that good governance practice is adhered to by directors and company officials (IOD 2002).

Woo-Nam and Nam (2004) argue against the inclusion of dominant institutional investors in the corporate governance framework. According to them the crucial cause of the poor performance of many corporations in East Asia was the inability to prevent dominant

shareholders from making key decisions single-handedly. As a result of this, dominant shareholders had a last say in all the key important issues such as the appointment of the chairperson of the board of directors, the appointment of the chief executive officer, any company reforms and external auditor's appointment. This left minority shareholders with little say in the affairs of company (Woo-Nam and Nam 2004).

Although the Corporate Laws Amendment Act, 2006 (RSA 2006) is silent in this regard, the Companies Bill, 2007 (RSA 2007) seeks to make it a legal offence to exclude minority shareholders when issues affecting the company are discussed, examples being mergers or amalgamations. Further to the above, the Companies Bill, 2007 (RSA 2007: sec. 164) allows a shareholder who does not wish to support a proposed merger or amalgamation to send an objection notice to the company. If the objection is not withdrawn, the shareholder may demand that the company pays to such shareholder the fair value of the shares if, amongst other things, the resolution for such action was supported by less than 75% of the shares entitled to vote.

The following subsections summarise corporate governance and the role of shareholders, in particular their relations and communications with the company.

4.18 SHAREHOLDERS' RIGHT TO VOTE

According to Woo-Nam and Nam (2004) there were a number of institutional barriers that stood in the way of shareholder participation in decision making on key issues before the economic crisis in Asia and few minority shareholders participated actively in decision making before 1997, because their incentives to attend general shareholders' meetings and exercise their rights were weak. After the crisis, in Korea, for example, shareholders' costs of participating in the decision-making process were reduced by allowing voting by mail (Woo-Nam & Nam 2004).

Currently, Korean shareholders can cast their votes on the agenda items of shareholders' meetings by mail if their companies adopt the new voting system. This is one of the developments in the shareholders' voting system in Korea (Woo-Nam & Nam 2004).

Woo-Nam and Nam (2004) argue that shareholders' rights to attend general shareholders' meetings and cast votes on various agenda items were reasonably well protected in Korea, Thailand, Indonesia and Malaysia, even before the economic crisis and, in addition to this, shareholders were notified of shareholders' meetings in advance and faced few problems in attending the meetings and casting their votes, while proxy voting was generally allowed. Woo-Nam and Nam (2004) attest to the fact that shareholders now have the right to vote on the following items:

- Appointing and removing directors and auditors;
- Authorising and issuing share capital;
- Amending the company's articles of association;
- Engaging in major corporate transactions; and
- Entering into transactions with related parties (Woo-Nam & Nam 2004).

The Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 21 (sec. 228 (1))) states that, notwithstanding anything contained in the company's memorandum or articles, the directors of a company shall not have the power, save by a special resolution of its members, to dispose of:

- The whole or the greater part of the undertaking of the company (RSA 2006: sec. 21 (sec. 228 (1) (a))); or
- The whole or the greater part of the assets of the company (RSA 2006: sec. 21 (sec. 228 (1) (b))).

Section 228 (2) of the Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 21 (sec. 228 (2))) further states that if in relation to the consolidated financial statements of a holding company, a disposal by any of its subsidiaries would constitute a disposal by the holding company in terms of subsection (l) (a) or (1) (b), such disposal requires a special resolution of the shareholders of the holding company (RSA 2006: sec. 21 (sec. 228 (2))).

Further to the above, Section 300A (2) requires that the designated auditor must attend every annual general meeting of a public-interest company where the financial statements of the company for a financial year are to be considered or agreed upon, so as to respond according to his or her knowledge and ability to any question from the shareholders relevant to the audit of the financial statements. Section 300A (3) further states that should the designated auditor fail to attend a meeting as required by subsection (2), the auditor is guilty of an offence, unless he/she provides acceptable explanations (RSA 2006: sec. 45 (sec. 300 (2) & (3))).

According to Deutsche Bank Securities Incorporated (2007: 10), South Africa recently introduced an electronic online proxy voting system. This will see more shareholders participating in a company's voting procedures. Previously shareholders submitted their proxy prior to the annual general meeting through a paper based-mailing system, compared to European and North American markets, this procedure was outdated and provided a disincentive for shareholders to submit their votes (Deutsche Bank Securities Incorporated 2007: 10).

The latest corporate governance survey carried out by the Deutsche Bank Securities Incorporated (2007: 11) assesses companies on their ability to accept electronic votes and the assessment reveals that South African companies are unable to comply and are disadvantaged. Deutsche Bank Securities Incorporated (2007: 11) recommends that South African companies need to amend their articles of association appropriately to be able to utilise the electronic proxy system.

4.19 CHECKLIST QUESTIONS ON SHAREHOLDERS PARTICIPATION

To determine the company's compliance with corporate governance requirements according to the King II report (IOD 2002), the following questions with regard to shareholders' participation in company affairs have been used to check if the top-40 JSE selected companies comply (refer to Appendix A (6)):

- Does the annual report of a company contain the information regarding shareholders' participation in company activities (shareholders' voting powers)?
- Does the annual report of a company clearly outline the duties and powers of company shareholders?

The above questions seek to determine if there is interaction between the company and its shareholders. Disclosure of this information in the annual report means that there is an interaction between the company and the shareholders, and that the company communicates all the necessary information to its shareholders.

4.20 COMPANY'S CODE OF ETHICS

The King II report (IOD 2002) requires a company to implement its code of ethics as part of corporate governance. This code of ethics should:

- Commit the company to the highest standard of behaviour;
- Be developed in such a way as to involve all stakeholders,
- Receive total commitment from the board and the CEO of a company, and
- Be sufficiently detailed to give clear guidance as to the expected behaviour of all employees in the company (IOD 2002).

The use of codes of ethics by professions is well known, for example, according to Farrell and Cobbin (2000: 183) codes of ethics are used by accountants as a control mechanism to ensure in part the adherence of its members to social agreements. The function of the code of ethics from the perspective of social contract theory is to achieve conformity through scientifically measurable outcomes enforced by sanctions (Farrell & Cobbin 2000).

Naidoo (2002: 140) argues that ethics are an aspirational objective and should represent the intrinsic cultural values of the society in which the company operates. Naidoo (2002: 140) further argues that there is no single, universally applicable model that can be defined as ethics. The use of codes of ethics by professions is well known, for example, according to Farrell and Cobbin (2000: 183) codes of ethics are used by accountants as a

control mechanism to ensure in part the adherence of its members to social agreements. The function of the code of ethics from the perspective of social contract theory is to achieve conformity through scientifically measurable outcomes enforced by sanctions (Farrell & Cobbin 2000).

The company should implement its code of ethics as part of its corporate governance disclosures. This code of ethics should commit the company to the highest standard of behaviour, be developed in a manner that includes all the stakeholders of the company, receive full backing from the board of directors and the CEO of a company and give clear guidance regarding the expected behaviour of all company employees (IOD 2002).

In the definition of the code of ethics in a company, Naidoo (2002: 140) recommends that the code should be defined in sufficient detail to give employees guidance on acceptable behaviour. Some of the examples cited by Naidoo (2002: 140) include trustworthiness, respect, honesty, responsibility, accountability, law-abiding behaviour, protection of the environment and the pursuit of excellence.

In 2007, the Centre for Professional and Business Studies of the University of Pretoria undertook a study on the ethics reporting practices of companies listed on the JSE. The University of Pretoria's study was based on the sustainability reports disclosed in the annual reports of listed companies that participate in the Socially Responsible Investment (SRI) Index of the JSE in South Africa and the focus was on how detailed reporting on ethics was in the annual reports (University of Pretoria 2007).

According to the University of Pretoria (2007: 4) all 55 SRI-JSE companies listed for 2007, reported their ethics policies in their annual reports. The study, however, reveals that the 100% result was obtained, based on the companies mentioning a code of conduct/ethics in their annual reports. Detailed results revealed that of the 55 SRI- JSE-listed companies, eight (14.5 %) developed a ticking-off compliance of the King II report (IOD 2002). The University of Pretoria (2007: 4) argues that these eight companies reported the existence of the code of ethics in the annual reports, however, no further detail of this code were mentioned.

Further empirical evidence on the disclosure of the information relating to the code of ethics in the annual reports of South African companies is found in the KPMG sustainability reporting survey (KPMG 2006). KPMG (2006: 4) reported that 70% of the top-100 JSE-listed companies partially reported their company's code of ethics in their 2006 annual reports compared to 29% in 2004. According to the survey, 50% of the annual reports in 2004 did not even refer to the code of ethics, while this percentage declined to 20% in 2006 (KPMG 2006).

From the above results presented by the KPMG (2006) survey and the University of Pretoria (2007), it is clear that South African companies continue to re-integrate into the global economy by attempting to apply international global reporting standards and that there is a growing ethical consciousness among South Africa's listed companies, while compliance with the King II report (IOD 2002) is improving. When observing the findings made by the University of Pretoria (2007) the main concern is the quality of these reports.

The University of Pretoria (2007: 1) poses the following questions regarding the quality of the disclosure of the ethics reports by companies:

- How seriously are ethical standards and policies being taken and to what extent are they being implemented and reported on by these companies?
- Are codes of conduct merely mentioned because they exist, or are more extensive accounts of the ethics management practices of these companies detailed in their annual and/or sustainability reports?

According to Naidoo (2002: 240), the management ethics in business and in the workplace has various benefits including the following:

- Ethics help maintain a moral course in times of fundamental change, cultivate strong teamwork and productivity and support employee growth;
- They help to ensure that policies and procedures are legal and ethical. Potential ethical issues and violations can be detected early in order that they can be reported and addressed;

- Ethics help manage values that are associated with quality management, strategic planning and diversity management, and promote a strong public image for the business; and
- They legitimise management actions, strengthen the coherence of the organisation's culture, improve trust in the relationships between individuals and groups, support greater consistency in standards and quality of products, and cultivate greater sensitivity to and awareness of the company's vision and values (Naidoo 2002).

Naidoo (2002: 141) further suggests the following guidelines in establishing the code of ethics in a company:

- Review of the values required by relevant laws and regulation;
- Identification of the values which produce the top three or four traits of a highly ethical and successful organisation, identifying the values which address current issues in the workplace, and consideration of any of the top ethical values that might be prized by stakeholders. From the above steps, the top five to ten ethical values that reflects the priorities of an organisation are then selected;
- Undertake a programme of self assessment to determine the existing status quo and the steps necessary to address the company's area of concern;
- Within the context of the values identified, establish organisational rules to manage ethics and define the company's operating values and behaviours. These rules may be simply a list of do's and don'ts or they may express the company's values in general terms. Whatever their form, it is important that the code be a living document suited to the company's specific needs;
- Align organisational behaviour with these operating values. It is important that the organisation be perceived to be living its code of ethics. In many companies, a multi-departmental ethics committee has become an effective supporting structure for the company's ethics initiatives;
- Undertake training to clarify the ethical values and enhance the ethical awareness of employees, to discuss the criteria of ethical decision making within the organisation, and to uncover and investigate ethical issues and concerns that directly relate to the

organisation. Training will help convince employees that attention to ethics are not just a knee-jerk reaction for getting out of trouble or improving public image;

- Establish the ongoing communication of the code to the employees and other stakeholders in the organisation. The development of ethics and fraud hotlines can lead to better enforcement of the code of ethics in an organisation;
- Enforce the code consistently and uniformly. Linked with the idea of a company living its code of ethics, consistency of application across all levels of the organisation is of fundamental importance. Develop awareness of and sensitivity to ethical values and integrate ethical guidelines into company decision-making;
- Measure and also audit the effectiveness of the programme consistently, for instance by monitoring the use of ethics hotlines, assessing feedback from training and conducting market research to gauge market perception about the ethical profile of the company;
- Facilitate pertinent revisions and refinements to the code to accommodate changing factual and moral standards; and
- Finally, no ethics or values initiatives should begin without the explicit, public commitment of the board and senior management to the long-term success of the process (Naidoo 2002:141).

4.21 CHECKLIST QUESTION ON COMPANY'S CODE OF ETHICS

To determine if the board has developed the company's code of ethics to comply with corporate governance requirements according to the King II report (IOD 2002), the following questions with regards to the disclosure of the company's code of ethics in its annual report have been used to check if the top-40 JSE selected companies comply (refer to Appendix A (7)):

- Has the company implemented a code of ethics that commits it to the highest standards of ethical behaviour, that involves all the company stakeholders and that clearly states the behaviour expected from all its employees?
- Does the company have communication channels for 'whistle blowers' e.g. anonymous emails and telephone lines?

The above questions seek to determine if there is a code of ethics that is clear on acceptable and unacceptable behaviour within the company. Disclosure of this information in the annual report informs the users of the annual report that a company has a transparent code of ethics that is familiar to all stakeholders and that there is commitment from the board of directors as well as top management in promoting high ethical standards within the company and that ethics are taken seriously in the company.

4.22 SUMMARY AND CONCLUSION

Discussions in this Chapter form the theoretical basis for the research instrument used in this study. The checklist used is based on the corporate governance requirements of the King II report and the Corporate Laws Amendment Act, 2006. Seven specific areas are identified, namely, the board and its directors, risk management and internal controls, internal audit, integrated sustainability reporting, accounting and auditing, relations and communication with company shareholders and the company's code of ethics. The questions included in the checklist are based on the King II requirements and the Corporate Laws Amendment Act, 2006 requirements.

The theoretical methodology to be followed in analysis of the contents of annual reports was discussed in detail. Word and meaning content analysis methodologies will be used for analysing the usefulness of information in the annual reports. The results obtained from using word and meaning content analysis will be benchmarked against the requirements of the King II report as well as those of the Corporate Laws Amendment Act, 2006 to assess if companies fully disclosed, partly disclosed or did not disclose the required information.

Each corporate governance category and its different sub-categories were explained in detail in Table 4.1. Table 4.2 provided the guidelines to score the disclosure of corporate governance information by the top-40 JSE listed companies. Appendix C provided the key word/s as well as the descriptions for searching for the required information in the annual reports as well as the disclosure requirements of the King II report and the Corporate Laws Amendment Act, 2006.

Chapter four provided a building block towards Chapter five which follows a practical approach, by analysing corporate governance reporting and assessing the usefulness of the corporate governance information disclosed in the annual reports of the top-40 listed South African companies. This analysis and assessment are based on qualitative content analysis which examines the disclosure of minimum corporate governance statements in the annual reports of the top-40 JSE listed companies and benchmarks this disclosure against the requirements of the King II report as well as the requirements of the Corporate Laws Amendment Act, 2006 to ascertain if companies fully disclosed, did not disclose and/or partly disclosed the required information.

CHAPTER 5

ANALYSIS OF RESEARCH FINDINGS

5.1 INTRODUCTION

Chapter 4 of this study discussed the content analysis method that was used to code the disclosure of minimum corporate governance information in the annual reports of the top-40 JSE listed companies. It further provided the background theory as well as the empirical evidence on the minimum corporate governance disclosures required by the King II report (IOD 2002) and the Corporate Laws Amendment Act, 2006 (RSA 2006) in South Africa. Detailed information on the requirements of the King II report and the Corporate Laws Amendment Act, 2006 appears in Appendix C.

Appendix A provides the checklist questions as per the requirements of the King II report (IOD 2002) and the Corporate Laws Amendment Act, 2006 (RSA 2006) outlined in Appendix C. Appendix B is used for the purpose of scoring companies based on the guidelines provided in Table 4.2 of Chapter 4 of this study. Word and meaning content analysis was used to code the information in the annual reports of the top-40 JSE listed companies in accordance with Table 4.1, in Chapter 4 and Appendix C.

This Chapter assesses corporate governance of the top-40 JSE listed companies using the checklist in Appendix A and benchmarking this according to the requirements outlined in Appendix C. The information that will be analysed is the information disclosed in the companies' annual reports. This information is presented graphically according to corporate governance categories namely, company's board and its directors, risk management and internal controls, internal audit, integrated sustainability reporting, accounting and auditing, shareholder activism and information on the company's code of ethics. Further to this, the information is tabulated per sector according to the FTSE Global Classification System appearing in Appendix E.

5.2 CLASSIFICATION OF THE ANNUAL REPORTS DOWNLOADED

TABLE 5.1 – SUPERSECTOR BREAKDOWN OF ANNUAL REPORTS

Supersector	Number of companies assessed per supersector
Banks	3
Basic Resources	14
Construction and Materials	2
Financial Services	4
Food and Beverages	2
Health Care	1
Industrial Goods and Services	2
Insurance	3
Media	1
Oil and Gas	1
Personal and Household Goods	4
Travel and Leisure	1
Telecommunications	2
Total	**40**

Table 5.1 above reflects the breakdown of annual reports downloaded on the top-40 JSE listed companies' websites. It classifies companies according to supersectors as recommended by the FTSE Global Classification System outlined in Appendix D of this study.

5.3 THE BOARD AND ITS DIRECTORS

5.3.1 Board responsibilities

FIGURE 5.1 – BOARD RESPONSIBILITIES

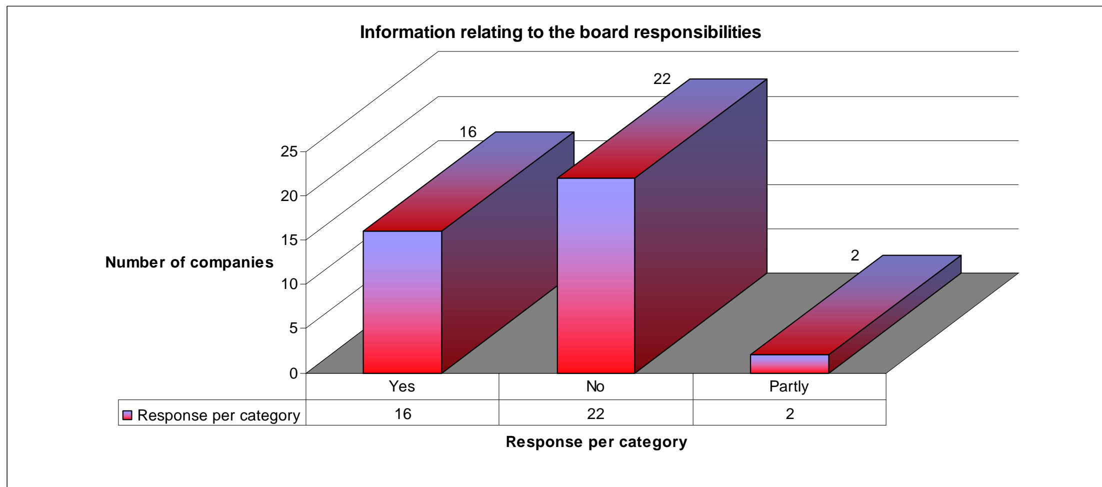


TABLE 5.2 – BOARD RESPONSIBILITIES

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	2	**66.7**	-	**-**	3
Basic Resources	6	**42.9**	6	**42.9**	2	**14.2**	14
Construction and Materials	-	**-**	2	**100**	-	**-**	2
Financial Services	3	**75**	1	**25**	-	**-**	4
Food and Beverages	-	**-**	2	**100**	-	**-**	2
Health Care	-	**-**	1	**100**	-	**-**	1
Industrial Goods and Services	2	**100**	-	**-**	-	**-**	2
Insurance	-	**-**	3	**100**	-	**-**	3
Media	-	**-**	1	**100**	-	**-**	1
Oil and Gas	1	**100**	-	**-**	-	**-**	1
Personal and Household Goods	3	**75**	1	**25**	-	**-**	4
Travel and Leisure	-	**-**	1	**100**	-	**-**	1
Telecommunications	-	**-**	2	**100**	-	**-**	2
Total	16	**40**	22	**55**	2	**5**	40

- means none

According to Figure 5.1 above, two companies which translate to 14.2% of the sampled resources sectors partly disclosed the information relating to the board responsibilities in their annual reports. These companies mentioned the fact that the board has certain responsibilities, i.e. the board is a focal point of corporate governance, but there were no further details of the board responsibilities. Further analysis in Table 5.2 above reveals that the two companies who partly disclosed their information were both from the basic resource sector. The part disclosure of board responsibilities information was 5% of the selected top-40 sample.

Figure 5.1 further revealed that 22 (55%) companies did not disclose their board responsibilities in their annual reports. The sector with the most companies who did not disclose their board responsibilities according to Table 5.2 above was the basic resources sector with six companies, which is 49.2% of the sampled basic resources sector, followed by the insurance sector with three, which is 100% of the sampled insurance sector, followed by the banking (66.7%), construction and material (100%), food and beverages (100%) and telecommunications (100%) sectors all with two companies each. The financial services (25%), health care (100%), media (100%), personal and household goods (25%) and travel and leisure (100%) sectors each had one company failing to disclose its board responsibilities in its annual reports. Companies who formed part of this category did not mention the existence of board responsibilities at all in their annual reports.

Figure 5.1 reveals that 16 (40%) companies fully disclosed their board responsibilities in their annual reports. According to Table 5.2 the sector that had most companies disclosing was the basic resource sector with six companies (42.9%) disclosing this information, followed by personal and household goods (75%) and financial services (75%) sectors both with three companies. The industrial goods and services sectors had two companies (100%) fully disclosing the board responsibilities information in its annual reports. Table 5.2 further reveals that oil and gas (100%) as well as the banking sector (33.3%) each had one company disclosing board responsibilities information in their annual reports. Companies who formed part of this category disclosed all the required information as per Appendix C.

5.3.2 Board size

FIGURE 5.2 – BOARD SIZE

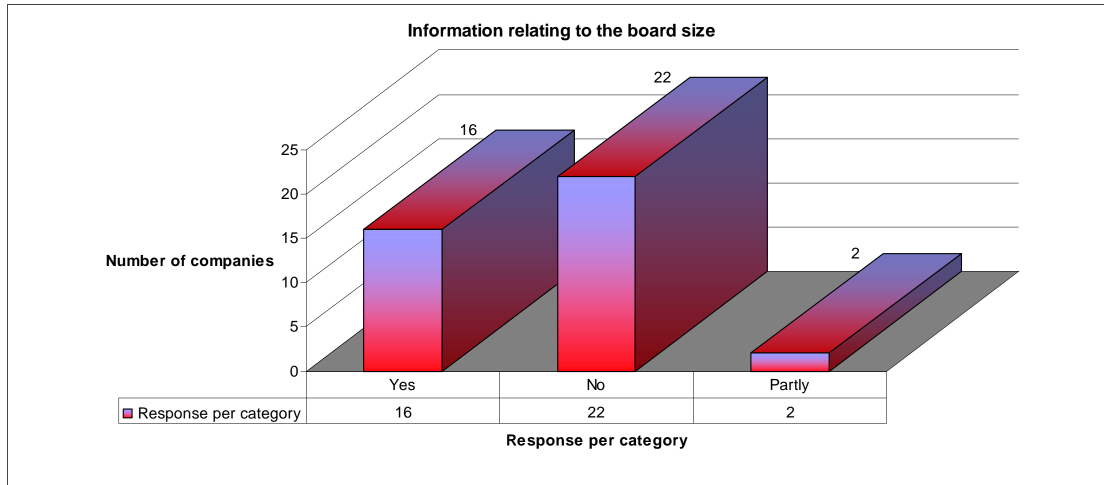


TABLE 5.3 – BOARD SIZE

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	2	**66.7**	-	**-**	3
Basic Resources	6	**42.9**	6	**42.9**	2	**14.2**	14
Construction and Materials	-	**-**	2	**100**	-	**-**	2
Financial Services	3	**75**	1	**25**	-	**-**	4
Food and Beverages	-	**-**	2	**100**	-	**-**	2
Health Care	-	**-**	1	**100**	-	**-**	1
Industrial Goods and Services	2	**100**	-	**-**	-	**-**	2
Insurance	-	**-**	3	**100**	-	**-**	3
Media	-	**-**	1	**100**	-	**-**	1
Oil and Gas	1	**100**	-	**-**	-	**-**	1
Personal and Household Goods	3	**75**	1	**25**	-	**-**	4
Travel and Leisure	-	**-**	1	**100**	-	**-**	1
Telecommunications	-	**-**	2	**100**	-	**-**	2
Total	16	**40**	22	**55**	2	**5**	40

- means none

According to Figure 5.2 above, two companies which translate to 14.2% of the sampled resources sector partly disclosed information relating to the board size in their annual reports. These companies mentioned the fact that there is a board of directors that has certain responsibilities, i.e. the board is a focal point of corporate governance, but there were no further details of its size. Further analysis of Table 5.2 above revealed that the two companies who partly disclosed their information were from the basic resources sector. The part disclosure of board size information was 5% of the selected top-40 sample.

Figure 5.2 further revealed that 22 (55%) companies did not disclose their board sizes in their annual reports. Most companies who did not disclose their board size according to Table 5.3 above were from the basic resources sector with six companies, which is 49.2% of the sampled resources sector, followed by the insurance sector with three, which is 100% of the sampled insurance sector, followed by the banking (66.7%), construction and material (100%), food and beverages (100%) and telecommunications (100%) sectors all with two companies each. The financial services (25%), health care (100%), media (100%), personal and household goods (25%) and travel and leisure (100%) sectors each had one company failing to disclose its board size in its annual report. Companies who formed part of this category did not mention the existence of board size in their annual reports.

Figure 5.2 reveals that 16 (40%) companies fully disclosed their board size in their annual reports. According to Table 5.2 the sector that had the most companies disclosing was the basic resource sector with six companies (42.9%) disclosing this information, followed by personal and household goods (75%) and financial services (75%) sectors both with three companies. The industrial goods and services sector had two companies (100%) fully disclosing the board size information in its annual reports. Table 5.2 further reveals that oil and gas (100%) as well as the banking sector (33.3%) each had one company disclosing the board size information in annual reports. Companies who formed part of this category disclosed all the required information as per Appendix C.

5.3.3 Board composition

FIGURE 5.3 – BOARD COMPOSITION

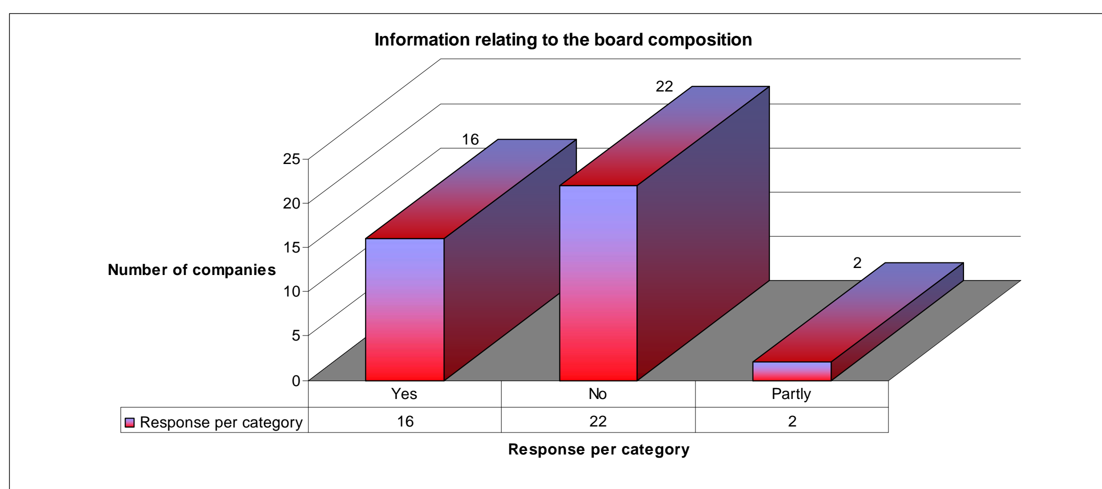


TABLE 5.4 – BOARD COMPOSITION

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	2	**66.7**	-	**-**	3
Basic Resources	6	**42.9**	6	**42.9**	2	**14.2**	14
Construction and Materials	-	**-**	2	**100**	-	**-**	2
Financial Services	3	**75**	1	**25**	-	**-**	4
Food and Beverages	-	**-**	2	**100**	-	**-**	2
Health Care	-	**-**	1	**100**	-	**-**	1
Industrial Goods and Services	2	**100**	-	**-**	-	**-**	2
Insurance	-	**-**	3	**100**	-	**-**	3
Media	-	**-**	1	**100**	-	**-**	1
Oil and Gas	1	**100**	-	**-**	-	**-**	1
Personal and Household Goods	3	**75**	1	**25**	-	**-**	4
Travel and Leisure	-	**-**	1	**100**	-	**-**	1
Telecommunications	-	**-**	2	**100**	-	**-**	2
Total	16	**40**	22	**55**	2	**5**	40

- means none

According to Figure 5.3 above, two companies (5%) partly disclosed information relating to board composition in their annual reports. Further analysis of Table 5.4 above reveals that the two companies who partly disclosed their information were from the basic resource sector, this translates to 14.2% of the sampled resource sector. Companies that partly disclosed the required information mentioned the fact that directors consist of both executive and non-executive directors, however, they did not reveal the nature of their directors, i.e. if the majority are independent non-executive directors.

Figure 5.3 further reveals that 22 (55%) companies did not disclose their board composition in their annual reports. Most companies who did not disclose their board composition according to Table 5.4 above, were from the basic resources sector (42.9%) with six companies, followed by the insurance sector (100%) with three, followed by banking (66.7%), construction and material (100%), food and beverages (100%) and the telecommunications sectors (100%) with two companies each. Financial services (25%), health care (100%), media (100%), personal and household goods (25%) and travel and leisure (100%) sectors each had one company failing to disclose its board composition in its annual reports. These companies also did not mention the manner in which their boards are composed.

Figure 5.3 reveals that 16 (40%) companies fully disclosed their board composition in their annual reports. According to Table 5.4 the sector that had most companies fully disclosing was the basic resources (42.9%) sector with six companies disclosing, followed by personal and household goods (75%) and financial services (75%), both with three companies disclosing. The industrial goods and services (100%) sector had two companies fully disclosing board composition information in their annual reports. Table 5.4 further reveals that the oil and gas (100%) as well as the banking (33.3%) sectors each had one company disclosing board composition information in their annual reports. These companies disclosed all the required information as per Appendix C.

The information relating to board responsibility in Figure 5.1 and board size in Table 5.2 and board composition in Figure 5.3 shows a correlation. This information reveals that companies, who fully disclosed, partly disclosed and those who did not disclose the information, scored the same in all the categories.

5.3.4 Board meetings

FIGURE 5.4 – BOARD MEETINGS

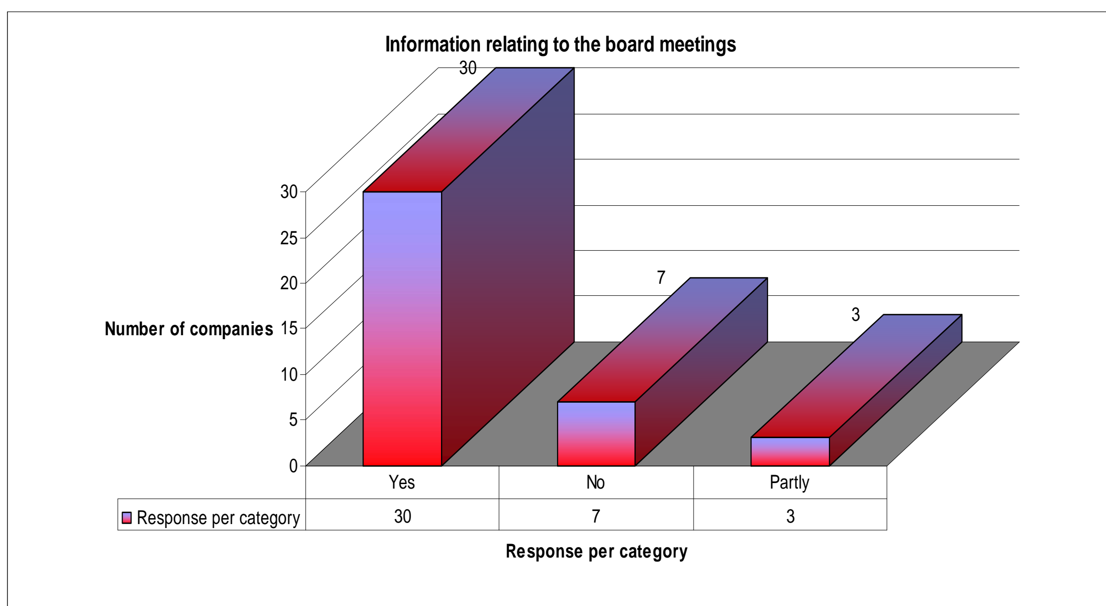


TABLE 5.5 – BOARD MEETINGS

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	2	**66.7**	1	**33.3**	-	**-**	3
Basic Resources	11	**78.6**	3	**21.4**	-	-	14
Construction and Materials	1	**50**	-	-	1	**50**	2
Financial Services	4	**100**	-	-	-	**-**	4
Food and Beverages	2	**100**	-	-	-	**-**	2
Health Care	-	**-**	1	**100**	-	**-**	1
Industrial Goods and Services	2	**100**	-	**-**	-	**-**	2
Insurance	2	**66.7**	1	**33.3**	-	**-**	3
Media	1	**100**	-	-	-	**-**	1
Oil and Gas	1	**100**	-	-	-	**-**	1
Personal and Household Goods	2	**50**	-	-	2	**50**	4
Travel and Leisure	1	**100**	-	-	-	**-**	1
Telecommunications	1	**50**	1	**50**	-	**-**	2
Total	30	**75**	7	**17.5**	3	**7.5**	40

- means none

According to Figure 5.4 and Table 5.5, 30 (75%) companies disclosed information relating to their board meetings in their annual reports. Further to the above, seven (17.5%) companies did not disclose this information at all, whilst three (7.5%) companies partly disclosed this information. Detailed analysis of the information relating to board meetings reveals that of the 30 companies that disclosed board meeting information, the basic resources sector recorded the highest disclosure with 11 (78.6%) companies disclosing board meeting information.

The next highest number of companies was in the financial services sector with four (100%) companies. The personal households and goods (50%), industrial goods and services (100%), insurance (66.7%) and banking (66.7%) and food and beverages (100%) sectors each had two companies recording this information in their annual reports.

Construction and materials (50%), travel and leisure (100%), oil and gas (100%) and media (100%) each recorded one company which disclosed information on board meetings in their annual reports. Companies who fully disclosed information relating to board meetings disclosed information such as the number of meetings held and the number of meetings attended by each director.

The basic resources sector had three (21.4%) companies that did not disclose board meeting information in their annual reports. The telecommunications (50%), healthcare (100%), insurance (33.3%) and banking (33.3%) sectors each had one company that did not disclose board meeting information. Further to the above, the personal and household goods (50%) sector recorded two companies that partly disclosed board meeting information in their annual reports, while the construction and material (50%) sector recorded one company that partly disclosed this information. Companies who partly disclosed information noted that board meetings were held, but there was no detail as to who attended these meetings and how many times the attendees actually attended.

5.3.5 Audit committees

FIGURE 5.5 – AUDIT COMMITTEES

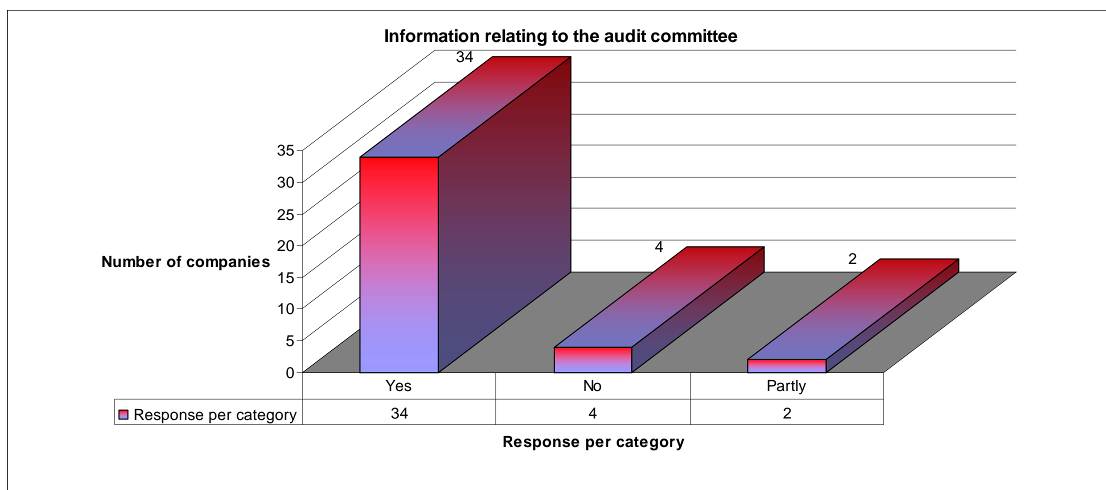


TABLE 5.6 – AUDIT COMMITTEES

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	2	**66.7**	1	**33.3**	-	**-**	3
Basic Resources	12	**85.8**	1	**7.1**	1	**7.1**	14
Construction and Materials	2	**100**	-	-	-	**-**	2
Financial Services	4	**100**	-	-	-	**-**	4
Food and Beverages	2	**100**	-	-	-	**-**	2
Health Care	**-**	**-**	1	**100**	-	**-**	1
Industrial Goods and Services	2	**100**	-	**-**	-	**-**	2
Insurance	2	**66.7**	-	-	1	**33.3**	3
Media	1	**100**	-	-	-	**-**	1
Oil and Gas	1	**100**	-	-	-	**-**	1
Personal and Household Goods	4	**100**	-	-	-	**-**	4
Travel and Leisure	1	**100**	-	-	-	**-**	1
Telecommunications	1	**50**	1	**50**	-	**-**	2
Total	34	**85**	4	**10**	2	**5**	40

- means none

Figure 5.5 above reflects disclosure of information relating to audit committees in the annual reports of the 40 companies analysed. According to the diagram above, 34 (85%) companies disclosed information relating to the activities of their audit committees in their 2006 annual reports. These annual reports further captured audit committee meetings held, compensation of committee members, committee charters and committee resolutions.

Figure 5.5 further reveals that four (10%) companies did not disclose anything relating to audit committees in their annual reports while two (5%) companies partly captured this information. Companies who partly disclosed this information only referred to the existence of audit committees as per the requirement stated in Appendix C, however no further details were available for analysis in these annual reports.

Detailed analysis of the information in Table 5.6 reveals that of the 34 companies that disclosed information relating to their audit committees, 12 (85.8%) companies were from the basic resources sector. The basic resources sector was followed by the financial services (100%) and personal and household goods (100%) sectors, both of which recorded four companies.

The banking (66.7%), construction and material (100%), food and beverages (100%), industrial goods and services (100%) and insurance (66.7%) sectors all had two companies that recorded audit committees information while the telecommunications (50%), travel and leisure (100%), oil and gas (100%) and media (100%) sectors each recorded one company.

Further analysis reveals that the telecommunications (50%), healthcare (100%), basic resources (7.1%) and banking (33.3%) sectors each recorded one company that did not disclose information relating to its audit committees in its annual reports. The basic resources (7.1%) and the insurance (33.3%) sectors each had one company that partly disclosed information relating to audit committees in their annual reports.

5.3.6 Remuneration committees

FIGURE 5.6 – REMUNERATION COMMITTEES

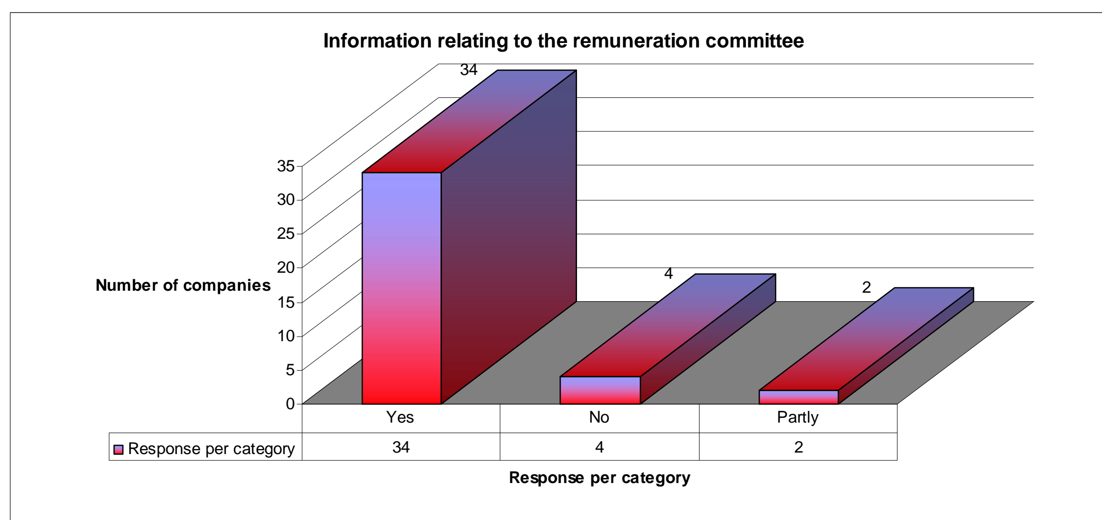


TABLE 5.7– REMUNERATION COMMITTEES

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	2	**66.7**	1	**33.3**	-	**-**	3
Basic resources	12	**85.8**	1	**7.1**	1	**7.1**	14
Construction and Materials	2	**100**	-	-	-	**-**	2
Financial Services	4	**100**	-	-	-	**-**	4
Food and Beverages	2	**100**	-	-	-	**-**	2
Health Care	**-**	**-**	1	**100**	-	**-**	1
Industrial Goods and Services	2	**100**	-	**-**	-	**-**	2
Insurance	2	**66.7**	-	-	1	**33.3**	3
Media	1	**100**	-	-	-	**-**	1
Oil and Gas	1	**100**	-	-	-	**-**	1
Personal and Household Goods	4	**100**	-	-	-	**-**	4
Travel and Leisure	1	**100**	-	-	-	**-**	1
Telecommunications	1	**50**	1	**50**	-	**-**	2
Total	34	**85**	4	**10**	2	**5**	40

- means none

Figure 5.6 above reflects the disclosure of information relating to remuneration committees in the annual reports of the 40 companies analysed. According to the diagram above, 34 (85%) companies disclosed information relating to the activities of their remuneration committees in their 2006 annual reports. These annual reports further captured remuneration committee meetings held, compensation of committee members, committee charters and committee resolutions.

Figure 5.6 further reveals that four (10%) companies did not disclose anything relating to remuneration committees in their annual reports, while two (5%) companies partly captured this information. Companies who partly disclosed this information only referred to the existence of remuneration committees as per the requirements stated in Appendix C, however no further details were available for analysis in these annual reports.

Detailed analysis of the information in Table 5.7 reveals that of the 34 companies that disclosed information relating to their remuneration committees, 12 (85.8%) companies were from the basic resources sector. The basic resources sector was followed by the financial services (100%) and personal and household goods (100%) sectors, both of which recorded four companies.

The banking (66.7%), construction and material (100%), food and beverages (100%), industrial goods and services (100%) and the insurance (66.7%) sectors all had two companies that recorded remuneration committee information while the telecommunications (50%), travel and leisure (100%), oil and gas (100%) and media (100%) sectors each recorded one company. Further analysis reveals that the telecommunications (50%), healthcare (100%), basic resources (7.1%) and banking (33.3%) sectors each recorded one company that did not disclose information relating to its remuneration committees in its annual reports. The basic resources (7.1%) and the insurance (33.3%) sectors each had one company that partly disclosed information relating to remuneration committees in their annual reports.

5.3.7 Risk management committees

FIGURE 5.7 – RISK MANAGEMENT COMMITTEES

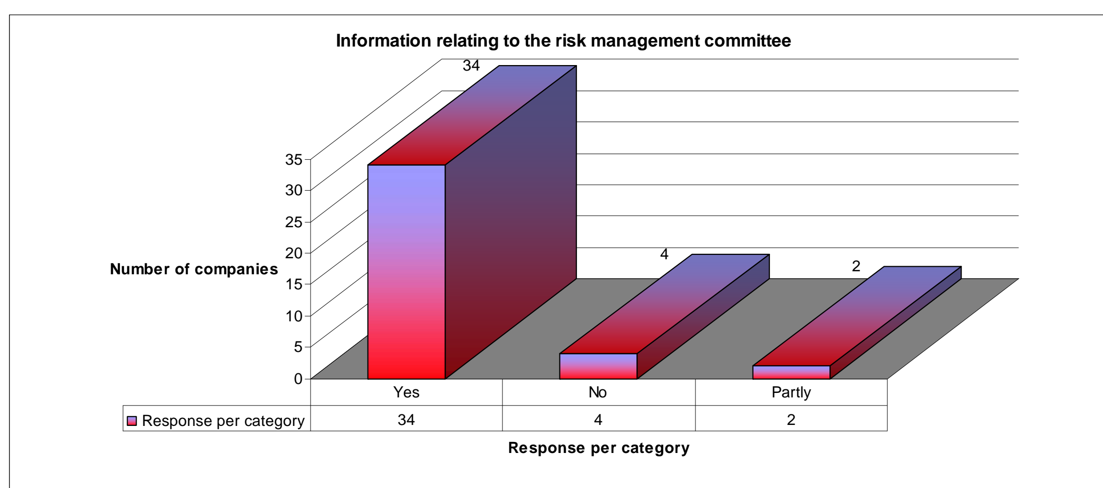


TABLE 5.8 – RISK MANAGEMENT COMMITTEES

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	2	**66.7**	1	**33.3**	-	**-**	3
Basic Resources	12	**85.8**	1	**7.1**	1	**7.1**	14
Construction and Materials	2	**100**	-	-	-	**-**	2
Financial Services	4	**100**	-	-	-	**-**	4
Food and Beverages	2	**100**	-	-	-	**-**	2
Health Care	**-**	**-**	1	**100**	-	**-**	1
Industrial Goods and Services	2	**100**	-	**-**	-	**-**	2
Insurance	2	**66.7**	-	-	1	**33.3**	3
Media	1	**100**	-	-	-	**-**	1
Oil and Gas	1	**100**	-	-	-	**-**	1
Personal and Household Goods	4	**100**	-	-	-	**-**	4
Travel and Leisure	1	**100**	-	-	-	**-**	1
Telecommunications	1	**50**	1	**50**	-	**-**	2
Total	34	**85**	4	**10**	2	**5**	40

- means none

Figure 5.7 above reflects disclosure of information relating to the risk management committees in the annual reports of the 40 companies analysed. According to Figure 5.7, 34 (85%) companies disclosed information relating to the activities of their risk management committees in their 2006 annual reports. These annual reports further captured risk management committee meetings held, compensation of committee members, committee charters and committee resolutions. Figure 5.7 further reveals that four (10%) companies did not disclose anything relating to risk management committees in their annual reports while two (5%) companies partly disclosed this information. Companies who partly disclosed this information only referred to the existence of risk management committees as per the requirement stated in Appendix C, however no further details were available for analysis in these annual reports.

Detailed analysis of the information in Table 5.8 reveals that of the 34 companies that disclosed information relating to their risk management committees, 12 (85.8%) companies were from the basic resources sector. The basic resources sector was followed by the financial services (100%) and personal and household goods (100%) sectors and both recorded four companies.

The banking (66.7%), construction and material (100%), food and beverages (100%), industrial goods and services (100%) and the insurance (66.7%) sectors all had two companies that recorded risk management committee information while the telecommunications (50%), travel and leisure (100%), oil and gas (100%) and media (100%) sectors each recorded one company. Further analysis revealed that the telecommunications (50%), healthcare (100%), basic resources (7.1%) and banking (33.3%) sectors each recorded one company that did not disclose information relating to its risk management committees in its annual reports. The basic resources (7.1%) and the insurance (33.3%) sectors each had one company that partly disclosed information relating to risk management committees in their annual reports.

5.3.8 Other board committees

FIGURE 5.8 – OTHER BOARD COMMITTEES

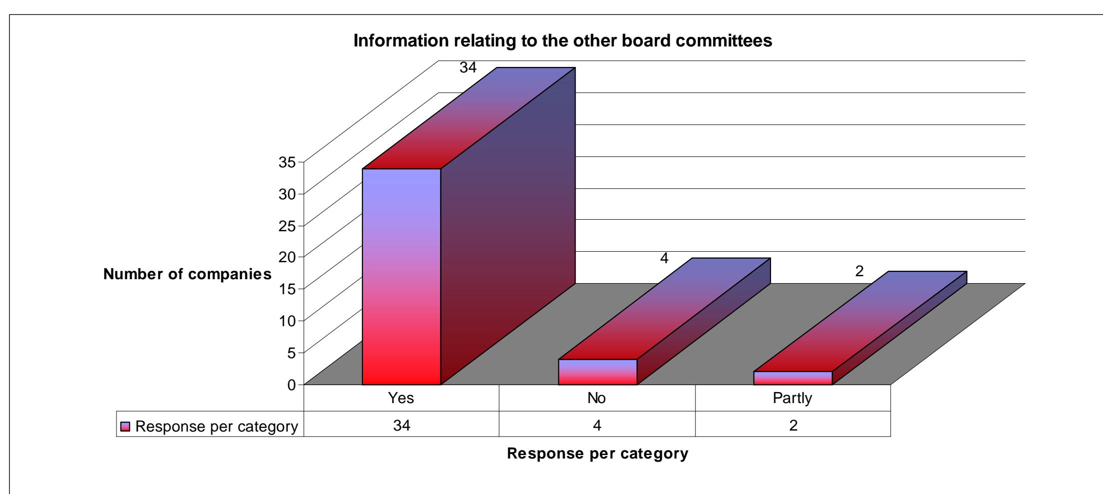


TABLE 5.9 – OTHER BOARD COMMITTEES

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	2	**66.7**	1	**33.3**	-	**-**	3
Basic Resources	12	**85.8**	1	**7.1**	1	**7.1**	14
Construction and Materials	2	**100**	-	-	-	**-**	2
Financial Services	4	**100**	-	-	-	**-**	4
Food and Beverages	2	**100**	-	-	-	**-**	2
Health Care	**-**	**-**	1	**100**	-	**-**	1
Industrial Goods and Services	2	**100**	-	**-**	-	**-**	2
Insurance	2	**66.7**	-	-	1	**33.3**	3
Media	1	**100**	-	-	-	**-**	1
Oil and Gas	1	**100**	-	-	-	**-**	1
Personal and Household Goods	4	**100**	-	-	-	**-**	4
Travel and Leisure	1	**100**	-	-	-	**-**	1
Telecommunications	1	**50**	1	**50**	-	**-**	2
Total	34	**85**	4	**10**	2	**5**	40

- means none

Other board committees include, among other committees, the nomination committee, the safety and sustainable development committee, the finance committee, the director affairs committee, the credit committee, the implementation committee, the audit and corporate governance committee, the employment equity & development committee, the executive committee, the investment committee, the market development committee, the political donations committee, the assets and liability committee and the tender committee.

Figure 5.8 above reflects the disclosure of information relating to other board committees in the annual reports of the 40 companies analysed. According to the results, 34 (85%) companies disclosed information relating to the activities of their other board committees in their 2006 annual reports. These annual reports further captured other above-mentioned

board committee meetings held, compensation of committee members, committee charters and committee resolutions.

Figure 5.8 further reveals that four (10%) companies did not disclose anything relating to other board committees in their annual reports while two (5%) companies partly disclosed this information. Companies who partly disclosed this information only referred to the existence of other board committees as per the requirements stated in Appendix C, however no further details were available for analysis in these annual reports.

Detailed analysis of the information in Table 5.9 reveals that of the 34 companies that disclosed the information relating to their other board committees, 12 (85.8%) companies were from the basic resources sector. The basic resources sector was followed by the financial services (100%) and personal and household goods (100%) sectors and both recorded four companies.

The banking (66.7%), construction and material (100%), food and beverages (100%), industrial goods and services (100%) and the insurance (66.7%) sectors all had two companies that recorded other board committee information while the telecommunications (50%), travel and leisure (100%), oil and gas (100%) and media (100%) sectors each recorded one company.

Further analysis reveals that the telecommunications (50%), healthcare (100%), basic resources (7.1%) and banking (33.3%) sectors each recorded one company that did not disclose information relating to its other board committees in its annual reports. The basic resources (7.1%) and the insurance (33.3%) sectors each had one company that partly disclosed information relating to other board committees in their annual reports.

Analysis of the information relating to other board committees reveals that companies who disclosed audit committee, remuneration committee and risk management information in their annual reports also disclosed information relating to their other board committees. This statement is illustrated by Tables 5.6, 5.7, 5.8 and 5.9.

5.4 RISK MANAGEMENT AND INTERNAL CONTROLS

5.4.1 Risk management information

FIGURE 5.9 – RISK MANAGEMENT INFORMATION

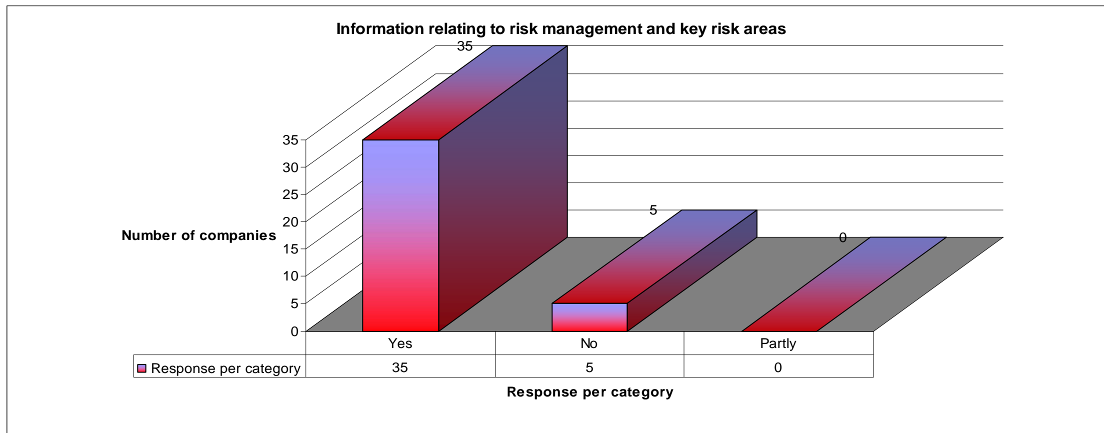


TABLE 5.10 – RISK MANAGEMENT INFORMATION

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	2	**66.7**	1	**33.3**	-	**-**	3
Basic Resources	13	**92.9**	1	**7.1**	-	-	14
Construction and Materials	2	**100**	-	-	-	**-**	2
Financial Services	4	**100**	-	-	-	**-**	4
Food and Beverages	2	**100**	-	-	-	**-**	2
Health Care	**-**	**-**	1	**100**	-	**-**	1
Industrial Goods and Services	2	**100**	-	**-**	-	**-**	2
Insurance	3	**100**	-	**-**	-	**-**	3
Media	1	**100**	-	-	-	**-**	1
Oil and Gas	1	**100**	-	-	-	**-**	1
Personal and Household Goods	3	**75**	1	**25**	-	**-**	4
Travel and Leisure	1	**100**	-	-	-	**-**	1
Telecommunications	1	**50**	1	**50**	-	**-**	2
Total	35	**87.5**	5	**12.5**	0	**0**	40

- means none

Figure 5.9 above reflects the disclosure of risk management information in the annual reports of the 40 companies. According to the diagram, 35 (87.5%) companies fully disclosed their risk management information in their annual reports for the 2006 financial year. Most annual reports which fell into this category disclosed information on the headline risk areas faced by a company as well as the risk mitigating factors used by a company. Some annual reports revealed the adequacy of internal controls as a tool to reduce internal risk, i.e. corruption etc. Figure 5.9 further reveals that five (12.5%) companies did not make any reference in the annual report to how they manage their risk. There are no companies that partly disclosed risk management information.

Detailed examination of the disclosure of risk management information in Table 5.10 reveals that of the 35 companies that fully disclosed risk management information in their annual reports 13 (92.9%) of them were from the basic resources sector. The basic resources sector was followed by the financial services sector with four (100%) companies disclosing information on risk management in their annual reports.

The insurance (100%) and the personal and household goods (75%) sectors both had three companies that disclosed risk management information. The construction and materials (100%), industrial goods and services (100%) the banking (66.7%), and food and beverages (100%) sectors each had two companies that fully disclosed information on risk management. The telecommunications (50%), travel and leisure (100%), media (100%), and oil and gas (100%) sectors all had one company which disclosed its risk management activities in the annual report.

Further examination of Table 5.10 reveals that there were five (12.5%) companies that did not disclose risk management information in their annual reports. The banking (33.3%), basic resources (7.1%), healthcare (100%), personal goods and services (25%), and telecommunications (50%) sectors each had one company that did not disclose risk management information in its annual report. Table 5.10 confirms that there is no sector that partly disclosed risk management information.

5.4.2 Adequacy of internal controls

FIGURE 5.10 – ADEQUACY OF INTERNAL CONTROLS

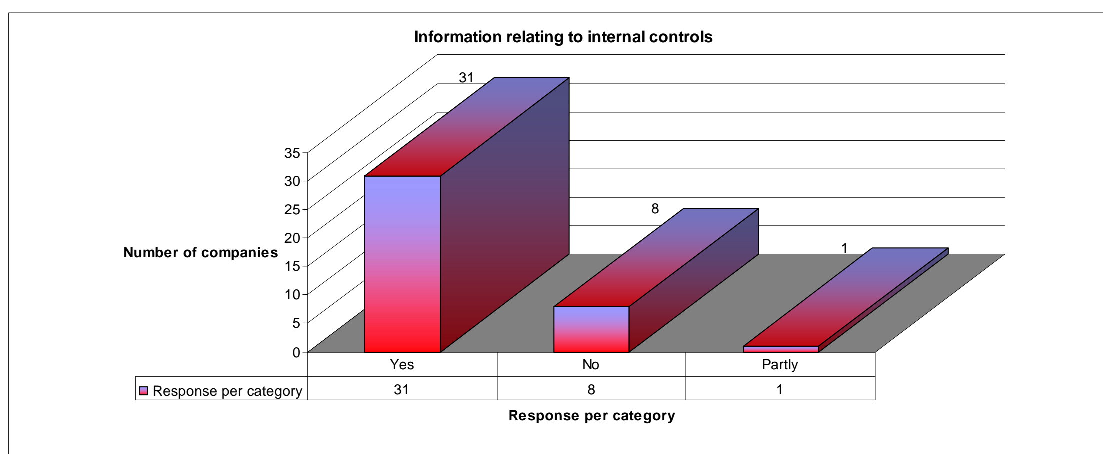


TABLE 5.11 – ADEQUACY OF INTERNAL CONTROLS

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	2	**66.7**	-	**-**	3
Basic Resources	13	**92.9**	1	**7.1**	-	-	14
Construction and Materials	2	**100**	-	-	-	**-**	2
Financial Services	3	**75**	1	**25**	-	**-**	4
Food and Beverages	2	**100**	-	-	-	**-**	2
Health Care	**-**	**-**	1	**100**	-	**-**	1
Industrial Goods and Services	2	**100**	-	**-**	-	**-**	2
Insurance	2	**66.7**	-	**-**	1	**33.3**	3
Media	**-**	**-**	1	**100**	-	**-**	1
Oil and Gas	1	**100**	-	-	-	**-**	1
Personal and Household Goods	3	**75**	1	**25**	-	**-**	4
Travel and Leisure	1	**100**	-	-	-	**-**	1
Telecommunications	1	**50**	1	**50**	-	**-**	2
Total	31	**77.5**	8	**20**	1	**2.5**	40

- means none

Analysis of the annual reports of the 40 companies reveals that only one (2.5%) company partly disclosed the information relating to its internal controls. The information disclosed by this company lacked depth, for example, it mentioned the existence of internal controls, however, there was no section in the annual report dealing with the adequacy of the internal controls and how the company tests this adequacy. Figure 5.10 reveals that 31 (77.5%) companies disclosed in detail the information relating to the adequacy of internal controls. These annual reports had a section dealing with internal controls in detail and companies disclosing this information went further by showing the relationship between internal audit and internal controls, internal audit and external audit as well as the risk mitigating strategies identified and implemented within the company. Figure 5.10 also reveals that eight (20%) companies did not have information relating to internal controls in their annual reports.

Detailed analysis of the internal control information in Table 5.11 reveals that most companies that fully disclosed information relating to their internal controls were from the basic resources sector with 13 (92.9%) companies, followed by the personal and household goods (75%) and financial services (75%) sectors both with three companies. The construction and materials (100%), food and beverages (100%), industrial goods and services (100%), and insurance (66.7%) sectors all had two companies which fully disclosed the nature of their internal controls in their annual reports. The oil and gas (100%), travel and leisure (100%), telecommunications (50%) and banking (33.3%) sectors all had one company disclosing the nature of their internal controls in their annual reports. Further to the above, the information analysed reveals that eight companies (20%) did not disclose information relating to their internal controls in the annual reports. The banking (66.7%) sector had two companies that did not disclose, whilst the basic resources (7.1%), financial services (25%), healthcare (100%), media (100%), personal and household goods (25%) and telecommunications (50%) sectors all had one company that did not disclose the nature of its internal controls in the annual report. There is one company that partly disclosed internal control information. Table 5.11 reveals that the company is from the insurance sector, translating into a 33% partial disclosure for this sector.

5.5 INTERNAL AUDIT

5.5.1 Internal audit independence

FIGURE 5.11 – INTERNAL AUDIT INDEPEDENCE

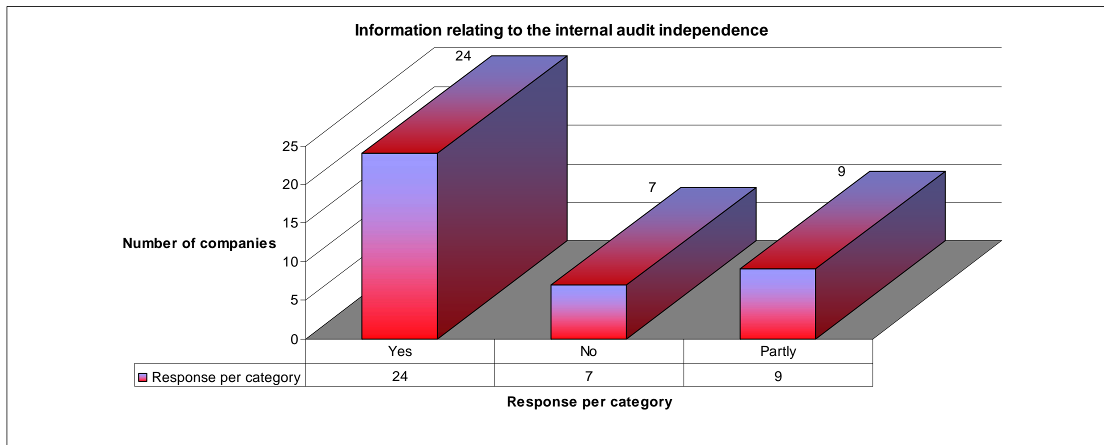


TABLE 5.12 – INTERNAL AUDIT INDEPENDENCE

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	-	-	2	**66.7**	3
Basic Resources	7	**50**	2	**14.3**	5	**35.7**	14
Construction and Materials	2	**100**	-	-	-	**-**	2
Financial Services	3	**75**	1	**25**	-	**-**	4
Food and Beverages	2	**100**	-	-	-	**-**	2
Health Care	**-**	**-**	1	**100**	-	**-**	1
Industrial Goods and Services	**-**	**-**	-	**-**	2	**100**	2
Insurance	2	**66.7**	1	**33.3**	-	**-**	3
Media	**-**	**-**	1	**100**	-	**-**	1
Oil and Gas	1	**100**	-	-	-	**-**	1
Personal and Household Goods	4	**100**	-	-	-	**-**	4
Travel and Leisure	1	**100**	-	-	-	**-**	1
Telecommunications	1	**50**	1	**50**	-	**-**	2
Total	24	**60**	7	**17.5**	9	**22.5**	40

- means none

According to Figure 5.11 above, there are 24 (60%) companies that fully disclosed the extent of their internal audit independence. Analysed information reveals that seven (17.5%) companies did not disclose information relating to their internal audit independence in their annual reports whilst nine (22.5%) companies partly disclosed this information in their annual reports. Detailed examination of the disclosure of information relating to internal audit independence is outlined in Table 5.12.

According to Table 5.12, of the 24 companies that fully disclosed information relating to internal audit independence in their annual reports, the basic resources sector had seven (50%) companies. This was followed by the personal and household goods (100%) sector with four companies and financial services (75%) sector with three companies that disclosed internal auditing independence. The construction and materials (100%), food and beverages (100%) and insurance (66.7%) sectors all had two companies that disclosed the extent of their internal audit independence in their annual reports whilst the banking (33.3%), oil and gas (100%), travel and leisure (100%) and telecommunication (50%) sectors all had one company disclosing this information. Companies that fully disclosed internal audit independence included their organisational structures to reflect how internal audit has been instituted.

Further analysis of Table 5.12 reflects that of the seven companies (17.5%) that did not disclose their internal audit independence information in their annual reports, the basic resources sector had two (14.3%) companies. The financial services (25%), health care (100%), insurance (33.3%), media (100%) and telecommunications (50%) sectors all had one company that did not disclose information on the internal audit independence. Five (35.7%) companies in the basic resources sector partly disclosed their information on internal audit independence whilst the banking (66.7%) and the industrial goods and services (100%) sectors each had two companies that partly disclosed this information. The companies who partly disclosed referred to internal audit independence without showing organisational structures and further details.

5.5.2 Risk management and internal audit divisions

FIGURE 5.12 – RISK MANAGEMENT AND INTERNAL AUDIT

TABLE 5.13 – RISK MANAGEMENT AND INTERNAL AUDIT

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	1	**33.3**	1	**33.3**	3
Basic Resources	10	**71.4**	2	**14.3**	2	**14.3**	14
Construction and Materials	2	**100**	-	-	-	-	2
Financial Services	4	**100**	-	-	-	-	4
Food and Beverages	2	**100**	-	-	-	-	2
Health Care	-	-	1	**100**	-	-	1
Industrial Goods and Services	1	**50**	-	-	1	**50**	2
Insurance	2	**75**	1	**25**	-	-	3
Media	-	-	1	**100**	-	-	1
Oil and Gas	1	**100**	-	-	-	-	1
Personal and Household Goods	4	**100**	-	-	-	-	4
Travel and Leisure	1	**100**	-	-	-	-	1
Telecommunications	1	**50**	1	**50**	-	-	2
Total	29	**72.5**	7	**17.5**	4	**10**	40

- means none

Figure 5.12 reflect the disclosure of the relationship between the risk management and internal audit divisions in annual reports. According to Figure 5.12, there were 29 (72.5%) companies that fully disclosed information relating to the relationship between risk management and internal audit divisions, seven (17.5%) companies that did not disclose this information in their annual reports whilst four (10%) companies partly disclosed this information. Companies which fully disclosed information demonstrated how the internal audit division relates to the risk management division. They went further to state that internal audit and risk management divisions were separate divisions, which complement each other in the risk identification processes. Companies which partly disclosed this information noted the existence of this relationship, but they did not provide information as to how the risk management division relates to the internal audit division.

Detailed analysis of the disclosure of this information is reflected by Table 5.13 above. According to Table 5.13, of the 29 companies that fully disclosed the relationship between the risk management and the internal audit division in their annual reports, ten were from the basic resources (71.4%) sector followed by four from the personal and household goods (100%) and financial services (100%) sectors. The construction and materials (100%), insurance (75%), and food and beverages (100%) sectors each had two companies which disclosed the relationship between the divisions whilst industrial goods and services (50%), banking (33.3%), oil and gas (100%), travel and leisure (100%) and telecommunications (50%) each had one company that recorded the relationship between risk management and internal audit divisions.

Table 5.13 further reveals that of the seven companies (17.5%) that did not disclose information relating to the relationship between the risk management and internal audit divisions, two of these companies (14.3%) were from the basic resources sector. The banking (33.3%), health care (100%), insurance (25%), media (100%) and telecommunication (50%) sectors each had one company that did not disclose this information.

According to Table 5.13, four companies (10%) partly disclosed information relating to the relationship between risk management and internal audit divisions. Of the four companies that partly disclosed this information, Table 5.13 reveals that two companies were from the basic resources (14.3%) sector whilst the banking (33.3%) and industrial goods and services (50%) sectors each had one company.

5.6 INTEGRATED SUSTAINABILITY REPORTING

The results of the study indicate a reasonably high percentage of companies that did not include integrated sustainability disclosures in their annual reports (health and safety issues 15 companies (37.5%), environmental issues 14 companies (35%) and social responsibilities 19 companies (47.5%). As this study was limited to the assessment of the annual reports of the top-40 JSE listed companies, integrated sustainability disclosures may form part of the other designated reports which do not fall within the ambit of this study.

5.6.1 Health and safety issues

FIGURE 5.13 – HEALTH AND SAFETY ISSUES

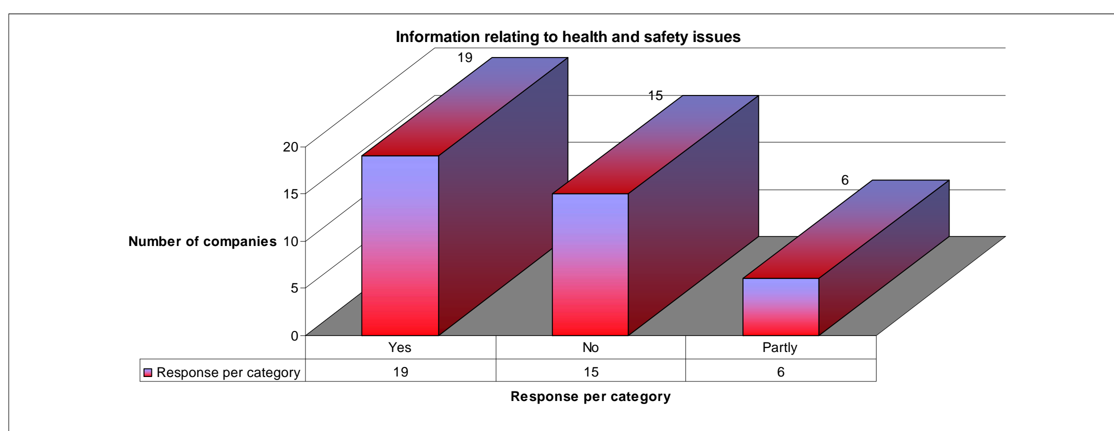


TABLE 5.14 – HEALTH AND SAFETY ISSUES

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	2	**66.7**	-	-	3
Basic Resources	9	**64.3**	3	**21.4**	2	**14.3**	14
Construction and Materials	2	**100**	-	-	-	**-**	2
Financial Services	1	**25**	2	**50**	1	**25**	4
Food and Beverages	1	**50**	1	**50**	-	**-**	2
Health Care	**-**	**-**	1	**100**	-	**-**	1
Industrial Goods and Services	1	**50**	1	**50**	-	**-**	2
Insurance	**-**	**-**	3	**100**	-	**-**	3
Media	1	**100**	-	-	-	**-**	1
Oil and Gas	**-**	**-**	-	-	1	**100**	1
Personal and Household Goods	2	**50**	1	**25**	1	**25**	4
Travel and Leisure	**-**	**-**	-	-	1	**100**	1
Telecommunications	1	**50**	1	**50**	-	**-**	2
Total	19	**47.5**	15	**37.5**	6	**15**	40

- means none

Figure 5.13 above reflect analysis of the disclosure of health and safety issues in the annual reports of the top-40 JSE listed companies. Figure 5.13 reveals that 19 (47.5%) companies fully disclosed health and safety issues in their annual reports. These companies disclosed the number of programmes that they have which ensure that their workforces are healthy and safe, while some companies also disclosed projects in the pipeline that will ensure employee safety and reduce fatalities in the working environment. Further to the above Figure 5.13 reveals that 15 (37.5%) annual reports made no reference to safety and health issues whilst six (15%) companies made little reference to health and safety issues, for example, these companies made a reference to the health and safety committees and the number of meetings held by these committees without revealing health and safety programmes in detail.

Detailed analysis of Table 5.14 reveals that the nine companies that fully disclosed health and safety issues were from the basic resources (64.3%) sector. The construction and materials (100%) and personal and household goods (50%) sectors both had two companies disclosing health and safety issues in their annual reports whilst banking (33.3%), financial services (25), food and beverages (50%), industrial goods and services (50%), media (100%) and telecommunications (50%) all had one company disclosing this information in their annual reports.

Further examination of the information relating to health and safety disclosures presented in Table 5.14 reveal that 15 companies (37.5%) did not disclose health and safety information in their annual reports, the basic resources (21.4%) and insurance (100%) sectors being the main sectors each with three companies, followed by the banking (66.7%) and financial services (50%) sectors with two companies. The food and beverages (50%), health care (100%), industrial goods and services (50%), personal and household goods (25%) and telecommunications (50%) sectors all recorded one company that did not disclose information on the health and safety issues. Two companies in the basic resources (14.3%) sector partly disclosed information relating to the health and safety issues whilst financial services (25%), oil and gas (100%), personal and household goods (25%) and travel and leisure (100%) each had one company that partly disclosed this information.

5.6.2 Environmental issues

FIGURE 5.14 – ENVIRONMENTAL ISSUES

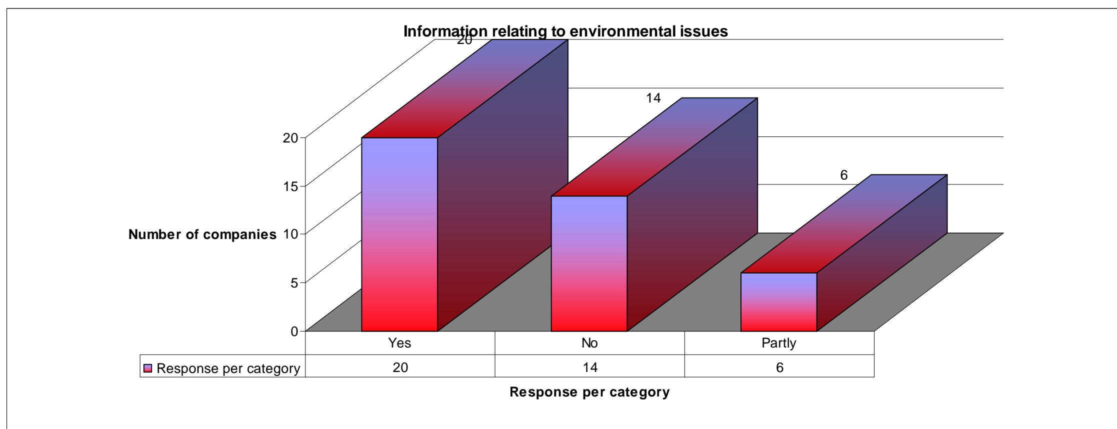


TABLE 5.15 – ENVIRONMENTAL ISSUES

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	2	**66.7**	-	-	3
Basic Resource	9	**64.3**	2	**14.3**	3	**21.4**	14
Construction and Materials	2	**100**	-	-	-	-	2
Financial Services	-	-	2	**50**	2	**50**	4
Food and Beverages	1	**50**	1	**50**	-	-	2
Health Care	-	-	1	**100**	-	-	1
Industrial Goods and Services	2	**100**	-	-	-	-	2
Insurance	1	**33.3**	2	**66.7**	-	-	3
Media	1	**100**	-	-	-	-	1
Oil and Gas	1	**100**	-	-	-	-	1
Personal and Household Goods	2	**50**	2	**50**	-	-	4
Travel and Leisure	-	-	-	-	1	**100**	1
Telecommunications	-	-	2	**100**	-	-	2
Total	20	**50**	14	**35**	6	**15**	40

- means none

Figure 5.14 above reflects the disclosure of environmental issues in the annual reports of the 40 companies analysed. According to Figure 5.14, 20 (50%) companies fully disclosed their environmental commitments in their annual reports. Some of the companies that fully disclosed environmental information in their annual reports went into detail to include items such as the amount that was spent to rehabilitate the environment.

Figure 5.14 further reflects that 14 (35%) companies did not make any reference to environmental issues in their annual reports while six (15%) companies made little reference to environmental issues. Companies that partly disclosed environmental issues made reference to the environmental laws affecting their respective companies but failed to detail their plans to keep the environment safe.

Detailed analysis of Table 5.15 reveals that of the 20 companies that fully disclosed the details of their environmental plans in their annual reports, nine companies were from the basic resources (64.3%) sector. This was followed by the personal and household goods (50%), industrial goods and services (100%), and construction and material (100%) sectors all with two companies disclosing environmental information in their annual reports. The banking (33.3%), food and beverages (50%), insurance (33.3%), media (100%) and oil and gas (100%) sectors all recorded one company which fully disclosed its impact on the environment.

Figure 5.15 further reveals that the banking (66.7%), financial services (50%), basic resources (14.3%), insurance (66.7%), personal and household goods (50%), and telecommunications (100%) sectors all recorded two companies that did not disclose environmental information in their annual reports whilst the food and beverages (50%) and health care (100%) sectors all recorded one company that did not disclose environmental information in its annual reports. Three companies from the basic resources (21.4%) sector partly disclosed environmental information followed by two companies in the financial services (50%) sector and one company in the travel and leisure (100%) sector.

5.6.3 Social responsibility

FIGURE 5.15 – SOCIAL RESPONSIBILITY

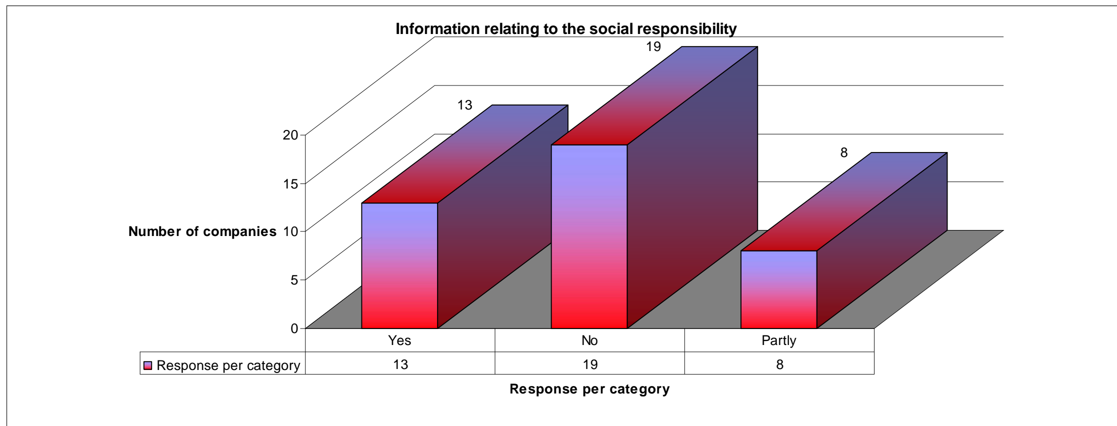


TABLE 5.16 – SOCIAL RESPONSIBILITY

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	2	**66.7**	-	-	3
Basic Resources	5	**35.7**	7	**50**	2	**14.3**	14
Construction and Materials	-	-	-	-	2	**100**	2
Financial Services	-	-	3	**75**	1	**25**	4
Food and Beverages	1	**50**	-	-	1	**50**	2
Health Care	-	-	1	**100**	-	-	1
Industrial Goods and Services	2	**100**	-	-	-	-	2
Insurance	1	**33.3**	2	**66.7**	-	-	3
Media	1	**100**	-	-	-	-	1
Oil and Gas	-	-	-	-	1	**100**	1
Personal and Household Goods	1	**25**	2	**50**	1	**25**	4
Travel and Leisure	-	-	1	**100**	-	-	1
Telecommunications	1	**50**	1	**50**	-	-	2
Total	13	**32.5**	19	**47.5**	8	**20**	40

- means none

According to Figure 5.15 and Table 5.16 above, 13 (32.5%) companies fully disclosed social responsibility information in their annual reports. Further to the above, 19 (47.5%) companies did not mention social responsibility in their annual reports whilst eight (20%) companies partly disclosed this information. Detailed analysis of the disclosure of social responsibility information is captured in Table 5.16. Companies that fully disclosed the information relating to social expenditure disclosed programmes such as building schools, bursaries, building houses and donations to the community. Companies that partly disclosed information relating to social expenditure mentioned the existence of social spending and strategies linked to education on how to become a good corporate citizen, however, this information was not detailed.

Table 5.16 reflects that five companies from the basic resources (35.7%) sector fully disclosed social responsibility information followed by the industrial goods and services sector (100%) with two companies that recorded social responsibility information. Telecommunications (50%), personal and household goods (25%), media (100%), insurance (33.3%), food and beverages (50%) and banks (33.3%) each recorded one company with social responsibility information in its annual reports.

Of the 19 companies (47.5%) that did not disclose social responsibility in their annual reports, seven companies were from the basic resources (50%) sector, followed by three companies from financial services (75%) and then two companies each from the banking (66.7%), insurance (66.7%), and personal and household goods (50%) sectors. Health care (100%), travel and leisure (100%) and telecommunications (50%) each recorded one company.

Table 5.16 further reveals that two companies each from the basic resources (14.3%) and construction and materials (100%) sectors partly disclosed social responsibility information in their annual reports, whilst the financial services (25%), food and beverages (50%), oil and gas (100%), and personal and household goods (25%) sectors each recorded one company.

5.6.4 Employment equity

FIGURE 5.16 – EMPLOYMENT EQUITY

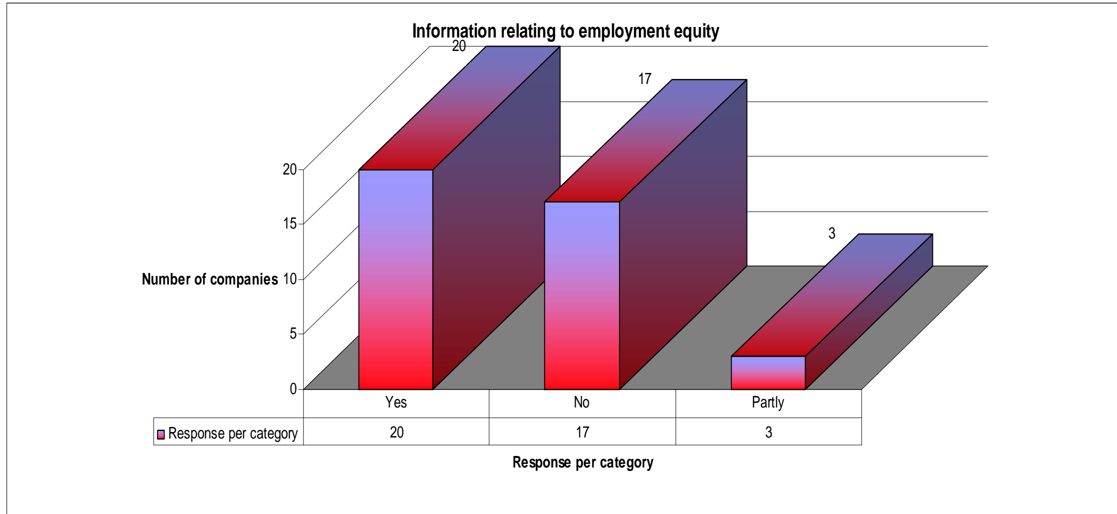


TABLE 5.17 – EMPLOYMENT EQUITY

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	2	**66.7**	-	-	3
Basic Resources	5	**35.7**	6	**42.9**	3	**21.4**	14
Construction and Materials	2	**100**	-	-	-	-	2
Financial Services	2	**50**	2	**50**	-	-	4
Food and Beverages	1	**50**	1	**50**	-	-	2
Health Care	-	**-**	1	**100**	-	**-**	1
Industrial Goods and Services	2	**100**	-	-	-	**-**	2
Insurance	1	**33.3**	2	**66.7**	-	**-**	3
Media	1	**100**	-	-	-	**-**	1
Oil and Gas	1	**100**	-	-	-	**-**	1
Personal and Household Goods	3	**75**	1	**25**	-	**-**	4
Travel and Leisure	-	**-**	1	**100**	-	**-**	1
Telecommunications	1	**50**	1	**50**	-	**-**	2
Total	20	**50**	17	**42.5**	3	**7.5**	40

- means none

Figure 5.16 analyses the disclosure of employment equity information in the annual reports. According to Figure 5.16, 20 (50%) companies made full disclosure with regards to their employment equity status. Some of these detailed annual reports incorporated a Table consisting of employees according to their race and gender. Of the 40 analysed companies, 17 (42.5%) did not make any reference to their employment equity issues in their annual reports, while three (7.5%) companies partly made the reference to their employment equity status. Companies that partly disclosed employment equity information in their annual report consist of those which made reference to the employment equity committee thereby signalling the existence of employment equity policies within the company. However, these companies did not provide detailed employment equity information in their annual reports.

Detailed examination of employment equity information revealed that five companies from the basic resources (35.7%) sector fully disclosed their employment equity information in their annual reports, followed by the personal and household goods (75%) sector with three companies. The construction and materials (100%), financial services (50%), and industrial goods and services (100%) sectors all recorded two companies that disclosed employment equity information. The banking (33.3%), food and beverages (50%), insurance (33.3%), media (100%), oil and gas (100%), and telecommunications (50%) sectors each recorded one company that fully disclosed employment equity information.

Further analysis of Table 5.17 reveals that six companies from the basic resources (42.9%) sector did not disclose information relating to employment equity followed by two companies from the financial services (50%), banking (66.7%) and insurance (66.7%) sectors. Food and beverages (50%), health care (100%), personal and household goods (25%), travel and leisure (100%) and telecommunications (50%) each recorded one company that did not disclose employment equity in their annual reports. All three companies (21.4%) that partly disclosed employment equity information in their annual reports were from the basic resources sector.

5.6.5 Human capital development

FIGURE 5.17 – HUMAN CAPITAL DEVELOPMENT

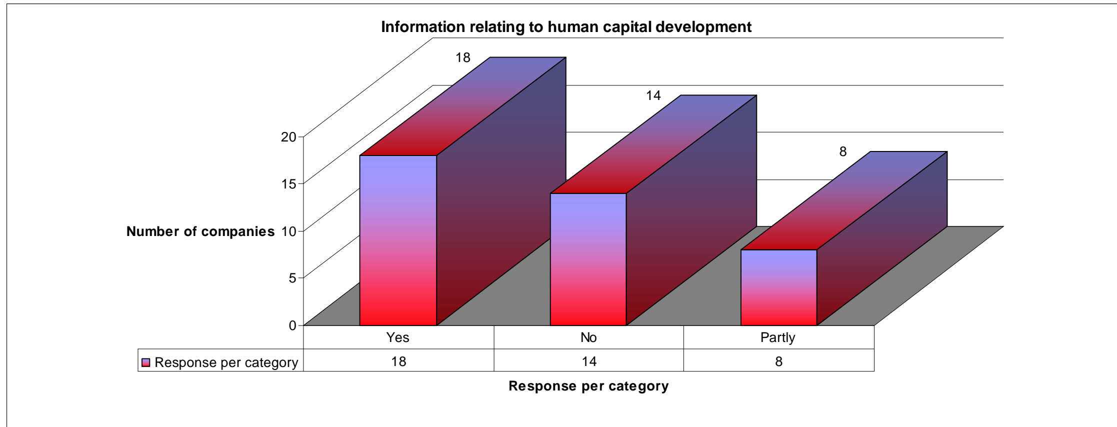


TABLE 5.18 – HUMAN CAPITAL DEVELOPMENT

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	2	**66.7**	-	-	3
Basic Resources	5	**35.7**	6	**42.9**	3	**21.4**	14
Construction and Materials	2	**100**	-	-	-	-	2
Financial Services	-	-	1	**25**	3	**75**	4
Food and Beverages	1	**50**	-	-	1	**50**	2
Health Care	-	**-**	1	**100**	-	**-**	1
Industrial Goods and Services	2	**100**	-	-	-	**-**	2
Insurance	1	**33.3**	1	**33.3**	1	**33.3**	3
Media	1	**100**	-	-	-	**-**	1
Oil and Gas	1	**100**	-	-	-	**-**	1
Personal and Household Goods	3	**75**	1	**25**	-	**-**	4
Travel and Leisure	-	**-**	1	**100**	-	**-**	1
Telecommunications	1	**50**	1	**50**	-	**-**	2
Total	18	**45**	14	**35**	8	**20**	40

- means none

Figure 5.17 above reflects the disclosure of human capital development in the annual reports of the 40 companies. According to the 2006 annual reports, of the 40 companies that were analysed, 18 (45%) annual reports disclosed human capital development information in their annual reports. Annual reports that fully disclosed human capital development captured information such as the company's commitment to improving skills amongst its employees by sending them on courses. Some annual reports incorporated a Table which reflected the number of employees that attended training during the 2006 financial year.

Figure 5.17 reveals that 14 (35%) companies did not make any reference at all to the human capacity development of their employees. Figure 5.17 further revealed that eight (20%) annual reports partly disclosed human capital development information. These annual reports only made reference to the human development committee signalling the existence of human capital development initiatives in these companies; however, no further information was provided.

Detailed analysis of the human capital development information presented in Table 5.18 above reflects that five companies from the basic resources (35.7%) sector fully disclosed their commitment to human capital development. This was followed by the personal and household goods (75%) sector which recorded three companies. Both the construction and materials (100%) and industrial goods and services (100%) sectors had two companies recording this information in their annual reports, whereas the banking (33.3%), food and beverages (50%), insurance (33.3%), media (100%), oil and gas (100%) and telecommunication (50%) sectors each recorded one company that disclosed human capital development in its annual reports.

Further to the above, Table 5.18 reveals that six companies from the basic resources (42.9%) sector did not disclose information relating to employment equity in their annual reports. This was followed by two companies in the banking (66.7%) sector whilst the financial services (25%), health care (100%), insurance (33.3%), personal and household

goods (25%), travel and leisure (100%), and telecommunication (50%) sectors each had one company that did not disclose human capital development information in its annual reports.

Table 5.18 reveals that of the eight companies (20%) that partly disclosed their human capital development information in their annual reports, three companies were from the basic resources (21.4%) and financial services (75%) sectors. The food and beverages (50%) and insurance (33.3%) sectors each had one company that did not disclose human capital development information in their annual reports.

5.6.6 Black economic empowerment (BEE)

FIGURE 5.18 – BLACK ECONOMIC EMPOWERMENT

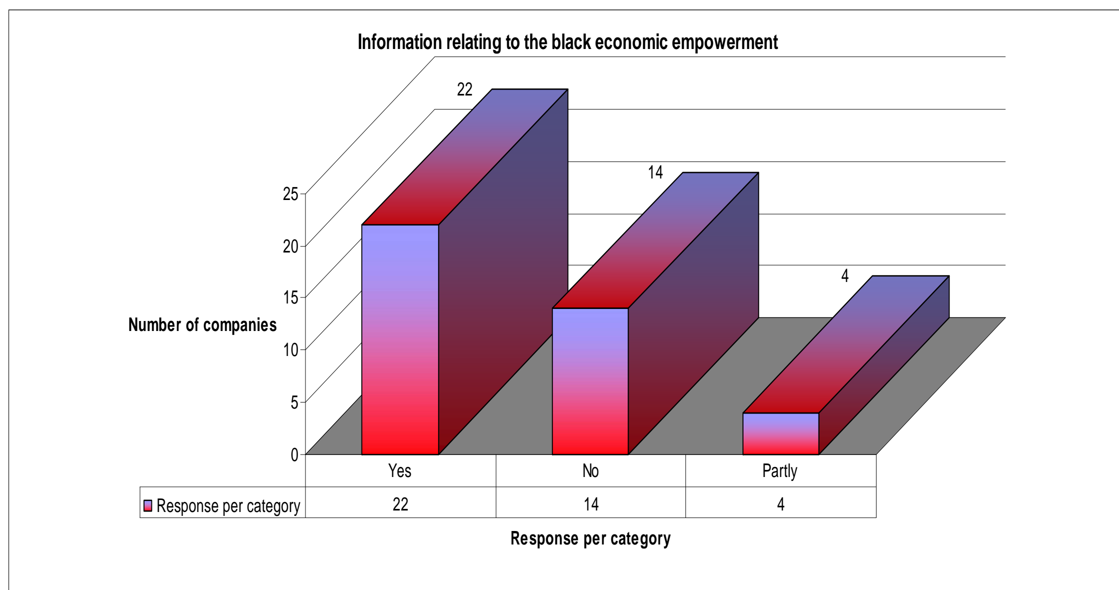


TABLE 5.19 – BLACK ECONOMIC EMPOWERMENT

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	2	**66.7**	-	-	3
Basic Resources	8	**57.2**	3	**21.4**	3	**21.4**	14
Construction and Materials	2	**100**	-	-	-	-	2
Financial Services	3	**75**	1	**25**	-	-	4
Food and Beverages	1	**50**	1	**50**	-	-	2
Health Care	-	**-**	1	**100**	-	-	1
Industrial Goods and Services	1	**50**	-	-	1	**50**	2
Insurance	1	**33.3**	2	**66.7**	-	**-**	3
Media	-	-	1	**100**	-	**-**	1
Oil and Gas	1	**100**	-	-	-	**-**	1
Personal and Household Goods	3	**75**	1	**25**	-	**-**	4
Travel and Leisure	-	**-**	1	**100**	-	**-**	1
Telecommunications	1	**50**	1	**50**	-	**-**	2
Total	22	**55**	14	**35**	4	**10**	40

- means none

According to Figure 5.18 above, 22 (55%) companies fully disclosed black economic empowerment (BEE) information in their annual report. Companies in this category disclosed information such as BEE transactions that they carried out during the year, as well as naming their BEE partners and BEE initiatives. Figure 5.18 further reveals that 14 (35%) companies did not disclose any information relating to BEE whilst four (10%) companies partly disclosed BEE information in their annual reports. Companies that partly disclosed BEE information disclosed little information, such as, the existence of BEE codes, but the extent of BEE was not disclosed in the annual reports.

The detailed information presented in Table 5.19 reveals that eight companies in the basic resources (57.2%) sector fully disclosed their BEE information. This was followed by three companies in both the financial services (75%) and personal and household goods (75%) sectors. Construction and material (100%) had two companies that fully disclosed BEE information in their annual reports whilst the banking (33.3%), food and beverages (50%), industrial goods and services (50%), insurance (33.3%), oil and gas (100%), and

telecommunications (50%) sectors each recorded one company as having fully disclosed BEE information in its annual report.

Of the 14 companies (35%) that did not disclose their BEE information, the basic resources (21.4%) sector had three companies, followed by both banking (66.7) and insurance (66.7%) sectors with two companies. The financial services (25%), food and beverages (50%), health care (100%), media (100%), personal and household goods (25%), travel and leisure (100%), and telecommunications (50%) sectors each recorded one company that did not disclose BEE information in its annual reports. Further to the above, Table 5.19 reveals that three companies in the basic resources (21.4%) sector partly disclosed BEE information in their annual reports whereas there was only one company in the industrial goods and services (50%) that partly disclosed the BEE information.

5.7 ACCOUNTING AND AUDITING

5.7.1 Relationship between internal and external auditors

FIGURE 5.19 – RELATIONSHIP BETWEEN INTERNAL AND EXTERNAL AUDITORS

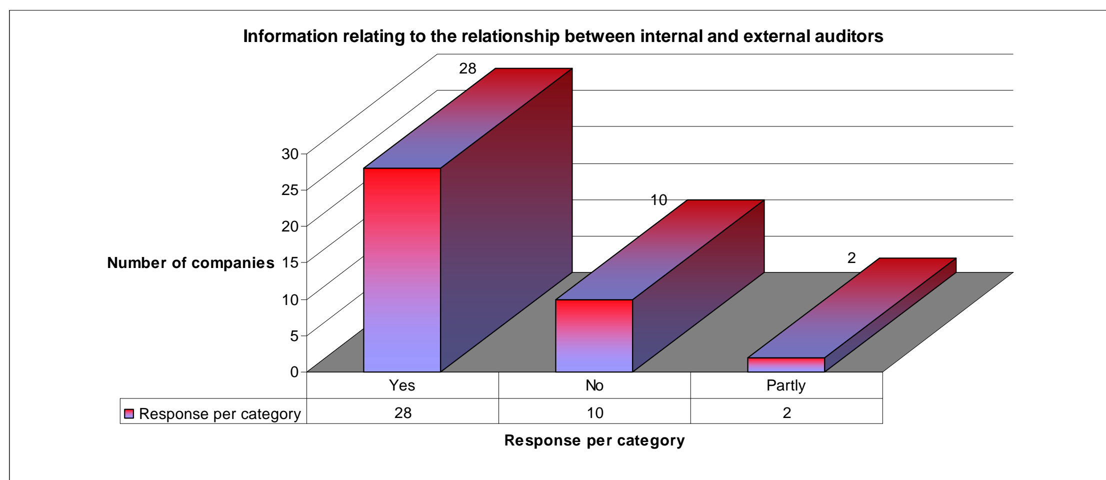


TABLE 5.20 – RELATIONSHIP BETWEEN INTERNAL AND EXTERNAL AUDITORS

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	2	**66.7**	-	-	3
Basic Resources	9	**64.3**	4	**28.6**	1	**7.1**	14
Construction and Materials	2	**100**	-	-	-	-	2
Financial Services	4	**100**	-	-	-	-	4
Food and Beverages	2	**100**	-	-	-	-	2
Health Care	-	**-**	1	**100**	-	-	1
Industrial Goods and Services	1	**50**	-	-	1	**50**	2
Insurance	2	**66.7**	1	**33.3**	-	**-**	3
Media	-	-	1	**100**	-	**-**	1
Oil and Gas	1	**100**	-	-	-	**-**	1
Personal and Household Goods	4	**100**	-	-	-	**-**	4
Travel and Leisure	1	**100**	-	-	-	**-**	1
Telecommunications	1	**50**	1	**50**	-	**-**	2
Total	28	**70**	10	**25**	2	**5**	40

- means none

Figure 5.19 above reflects the disclosure of the relationship between internal and the external auditors in annual reports. According to Figure 5.19, 28 companies (70%) disclosed information relating to the relationship between internal and external auditors in their annual reports. These annual reports included information such as internal and external audit independence, attendance of audit committee meetings by internal and external auditors and the organisational structure of how these two auditors relate to one another.

Figure 5.19 further reveals that ten companies (25%) did not refer to any information relating to the relationship between internal and external auditors in their annual reports whereas two companies (5%) partly captured the relationship between internal and external

audit. Companies that partly captured the information relating to the relationship between internal and external auditors mentioned this relationship, however, there was no further detail on how the relationship is handled, i.e. how these auditors relate to one another. Detailed analysis of the information regarding the relationship between internal and external auditors is reflected by Table 5.20.

According to this Table (5.20), nine companies from the basic resources (64.3%) sector disclosed information regarding the relationship between internal and external auditors. This was followed by the financial services (100%) and the personal and household goods (100%) sector both with four companies. Constructions and materials (100%), food and beverages (100%), and insurance (66.7%) all recorded two companies. The banking (33.3%), industrial goods and services (50%) and telecommunications (50%) all had one company disclosing the relationship between internal and external auditors.

Table 5.20 further reveals that four companies from the basic resources (28.6%) sector did not disclose the information in their annual reports. This was followed by the non-disclosure of information relating to the relationship between internal and external auditors by two companies in the banking sector (66.7%). Telecommunications (50%), media (100%), insurance (33.3%), and health care (100%) each had one company that did not disclose information relating to the relationship between the internal and external auditors in their annual reports. Two companies that partly disclosed the relationship between internal and external auditors were each from the basic resources (7.1%) and industrial goods and services (50%) sectors.

5.7.2 Selection of the external auditor

FIGURE 5.20 – SELECTION OF THE EXTERNAL AUDITOR

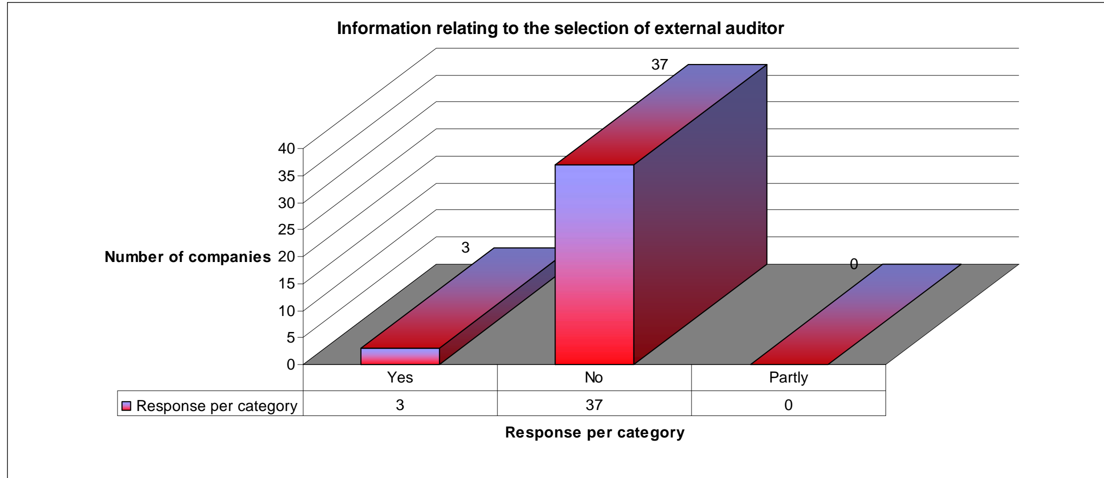


TABLE 5.21 – SELECTION OF THE EXTERNAL AUDITOR

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	2	**66.7**	-	-	3
Basic Resources	-	-	14	**100**	-	-	14
Construction and Materials	-	-	2	**100**	-	-	2
Financial Services	-	-	4	**100**	-	-	4
Food and Beverages	1	**50**	1	**50**	-	-	2
Health Care	-	-	1	**100**	-	-	1
Industrial Goods and Services	-	-	2	**100**	-	-	2
Insurance	-	-	3	**100**	-	-	3
Media	-	-	1	**100**	-	-	1
Oil and Gas	-	-	1	**100**	-	-	1
Personal and Household Goods	1	**25**	3	**75**	-	-	4
Travel and Leisure	-	-	1	**100**	-	-	1
Telecommunications	-	-	2	**100**	-	-	2
Total	3	**7.5**	37	**92.5**	0	**0**	40

- means none

Figure 5.20 above reflects the disclosure of information relating to the appointment/selection of external auditors. Almost all companies did not report on the appointment of their external auditors in their annual reports. According to the information analysed, 37 (92.5%) companies did not disclose information relating to the appointment of external auditors in their annual reports. There is no annual report that partly captures the appointment of external auditors, whereas there were three (7.5%) companies that reported the appointment of their external auditors. The annual reports that fully captured the required information explained the manner in which the external auditor was appointed and the fact that they were independent of management; they also explained the number of years that the external auditor will be with the company as well as the date of appointment of the external auditor.

Examination of Table 5.21 above reveals that companies that disclosed the selection/appointment of external auditors in their annual reports were each from the banking (33.3%), food and beverages (50%) and personal and household goods (25%) sectors. 14 companies in the basic resources (100%) sector did not disclose information relating to the selection of external auditors in their annual reports. This was followed by the financial services (100%) sector with four companies. Personal and household goods (75%) and insurance (100%) both recorded three companies as not having disclosed the information in their annual reports.

Table 5.21 further reveals that two companies in each of the banking (66.7%), construction and materials (100%), industrial goods and services (100%), and telecommunications (100%) sectors did not disclose the manner in which their external auditors are selected/ appointed. The food and beverages (50%), health care (100%), media (100%), oil and gas (100%) and travel and leisure (100%) sectors all had one company that did not disclose the manner in which their external auditors are selected/ appointed in their annual reports.

5.7.3 Audit report

FIGURE 5.21 – AUDIT REPORT

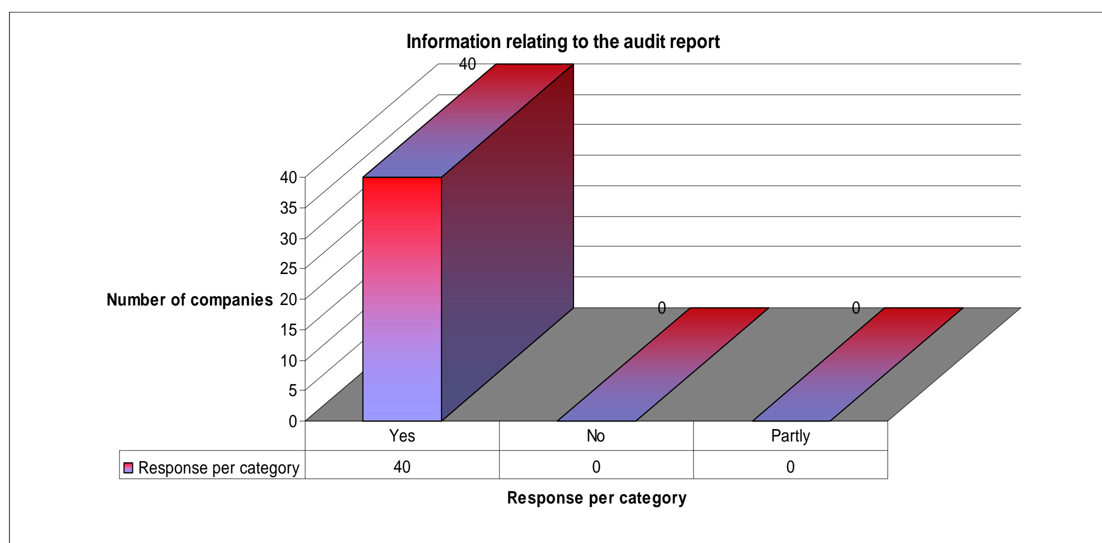


TABLE 5.22 – AUDIT REPORT

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	3	**100**	-	-	-	-	3
Basic Resources	14	**100**	-	-	-	-	14
Construction and Materials	2	**100**	-	-	-	-	2
Financial Services	4	**100**	-	-	-	-	4
Food and Beverages	2	**100**	-	-	-	-	2
Health Care	1	**100**	-	-	-	-	1
Industrial Goods and Services	2	**100**	-	-	-	-	2
Insurance	3	**100**	-	-	-	-	3
Media	1	**100**	-	-	-	-	1
Oil and Gas	1	**100**	-	-	-	-	1
Personal and Household Goods	4	**100**	-	-	-	-	4
Travel and Leisure	1	**100**	-	-	-	-	1
Telecommunications	2	**100**	-	-	-	-	2
Total	40	**100**	0	**0**	0	**0**	40

- means none

Figure 5.21 above reflects the attachment of the audit report to the annual reports of companies. According to Figure 5.21 all 40 companies assessed were audited and the audit reports were attached to their annual reports. There is no company that neither captured partly nor did not attach the audit report to its annual report. Even though it was supposed that the top-40 JSE listed companies will fully disclose this information because of its statutory nature (see the paragraph below), for completeness, it was felt that the disclosure of information relating to the audit reports in the annual reports of the top-40 JSE listed companies should also be tested.

The above finding can be ascribed to the statutory duty of an external auditor (RSA 1973: sec. 301) which requires the external auditor to report to the members of a company that the annual financial statements of that company was audited and whether they fairly present the financial position of the company and the results of its operations in the manner required by the Act.

5.8 RELATIONSHIP AND COMMUNICATIONS WITH COMPANY SHAREHOLDERS

5.8.1 Shareholder participation

FIGURE 5.22 – SHAREHOLDER PARTICIPATION

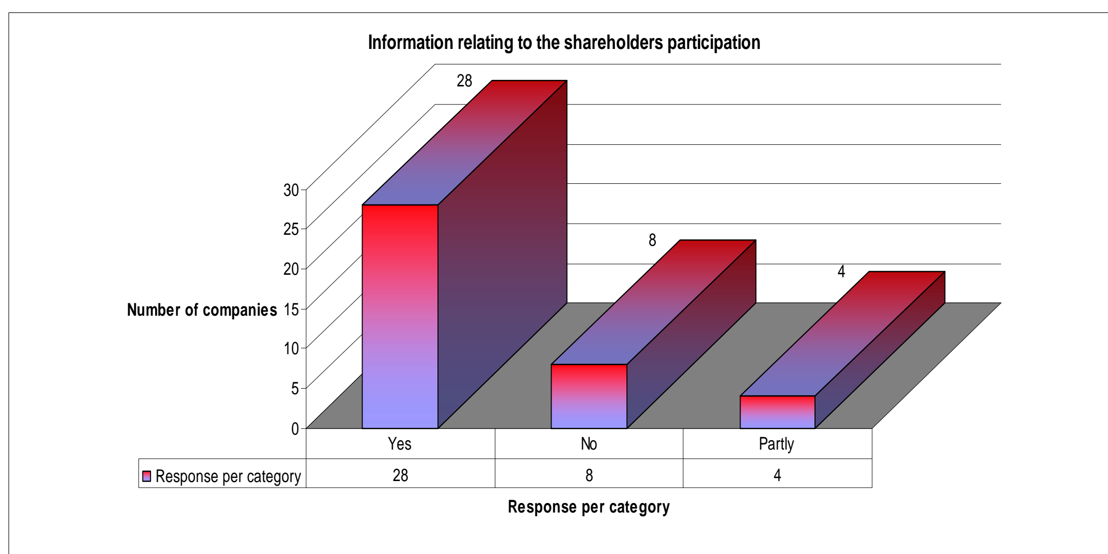


TABLE 5.23 – SHAREHOLDER PARTICIPATION

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	1	**33.3**	1	**33.3**	3
Basic Resources	8	**57.2**	5	**35.7**	1	**7.1**	14
Construction and Materials	2	**100**	-	-	-	-	2
Financial Services	4	**100**	-	-	-	-	4
Food and Beverages	2	**100**	-	-	-	-	2
Health Care	-	**-**	1	**100**	-	-	1
Industrial Goods and Services	1	**50**	-	-	1	**50**	2
Insurance	2	**66.7**	-	-	1	**33.3**	3
Media	1	**100**	-	-	-	**-**	1
Oil and Gas	1	**100**	-	-	-	**-**	1
Personal and Household Goods	4	**100**	-	-	-	**-**	4
Travel and Leisure	1	**100**	-	-	-	**-**	1
Telecommunications	1	**50**	1	**50**	-	**-**	2
Total	28	**70**	8	**20**	4	**10**	40

- means none

Figure 5.22 above reflects the disclosure of information regarding shareholder participation in the annual reports of companies. According to the diagram above, 28 (70%) out of 40 companies fully disclosed shareholder participation information in their annual reports. These companies incorporated subsections in their annual reports dealing with shareholder participation. These subsections contained information such as the attendance of AGMs and dates of future AGMs, the declaration of dividends to shareholders and the contents of booklets used for communicating with company shareholders.

Further to the above, Figure 5.22 reflects that eight (20%) companies did not disclose shareholder participation at all and four (10%) companies partly disclosed shareholder participation. Companies that partly disclosed this information mentioned that there are communication lines between directors and shareholders, however, they were not clear on how these communications are handled i.e. whether these are communications during the AGM or communicating financial results in newspapers or by means of booklets.

Detailed analysis of Table 5.23 above reflects that of the 28 companies (70%) that fully disclosed information relating to shareholder participation in their annual reports, eight companies were from the basic resources (57.2%) sector. The basic resources sector was followed by the financial services (100%) and personal and household goods (100%) sectors both with four companies. The construction and materials (100%), food and beverages (100%), and insurance (66.7%) sectors each recorded two companies as having fully disclosed information relating to the shareholder participation. Banking (33.3%), industrial goods and services (50%), media (100%), oil and gas (100%), travel and leisure (100%) and telecommunications (50%) each recorded one company.

Further examination of Table 5.23 reveals that five companies in the basic resources (35.7%) sector did not disclose information relating to shareholder participation. This was followed by companies in banking (33.3%), health care (100%), and telecommunications (50%) which each recorded one company that did not disclose information relating to shareholder participation. Single companies that partly disclosed shareholder participation were each from the banking (33.3%), basic resources (7.1%), industrial goods and services (50%) and insurance (33.3%) sectors.

5.8.2 Duties and powers of company shareholders

FIGURE 5.23 – DUTIES AND POWERS OF SHAREHOLDERS

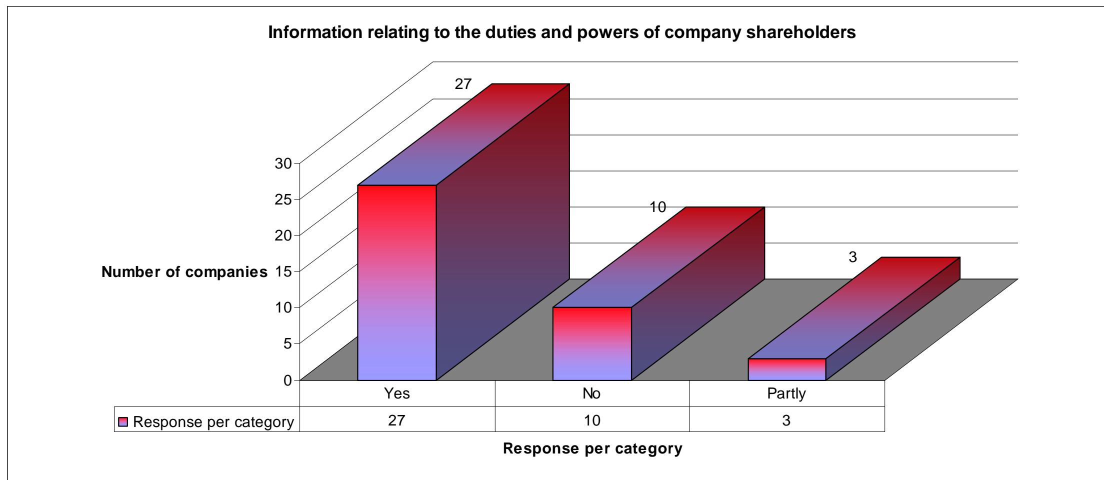


TABLE 5.24 – DUTIES AND POWERS OF SHAREHOLDERS

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	1	**33.3**	1	**33.3**	3
Basic Resources	8	**57.2**	5	**35.7**	1	**7.1**	14
Construction and Materials	2	**100**	-	-	-	-	2
Financial Services	4	**100**	-	-	-	-	4
Food and Beverages	2	**100**	-	-	-	-	2
Health Care	-	**-**	1	**100**	-	-	1
Industrial Goods and Services	1	**50**	1	**50**	-	-	2
Insurance	1	**33.3**	1	**33.3**	1	**33.3**	3
Media	1	**100**	-	-	-	**-**	1
Oil and Gas	1	**100**	-	-	-	**-**	1
Personal and Household Goods	4	**100**	-	-	-	**-**	4
Travel and Leisure	1	**100**	-	-	-	**-**	1
Telecommunications	1	**50**	1	**50**	-	**-**	2
Total	27	**67.5**	10	**25**	3	**7.5**	40

- means none

Figure 5.23 above reflects the disclosure of information relating to the duties and powers of company shareholders in annual reports. According to the data assessed, 27 (67.5%) companies disclosed the duties and powers of company shareholders in their annual report. Amongst the duties and powers were the use of the annual general meeting (AGM) by shareholders to appoint and remove the board, the power of the AGM to approve additional numbers of shares and the power of the AGM to appoint or dismiss external auditors.

According to Figure 5.23, out of the 40 companies, ten (25%) did not include information relating to the duties and powers of company shareholders in their annual reports whilst three (7.5%) companies partly disclosed the duties and powers of company shareholders in the annual report. Companies that partly disclosed information relating to the duties and powers of company shareholders mentioned the purpose of the AGM, but shareholders' powers were not outlined. Information such as the decisions made by shareholders at the AGM was not included. Details of the disclosure of information relating to the duties and powers of company shareholders are reflected in Table 5.24.

According to Table 5.24, there were eight companies in the basic resource (57.2%) sector that disclosed information relating to the duties and powers of company shareholders. The basic resources sector was followed by financial services (100%) and personal and household goods (100%) both with four companies. The food and beverages (100%) and construction and materials (100%) sectors reflected two companies each. Banking (33.3%), industrial goods and services (50%), insurance (33.3%), media (100%), oil and gas (100%), travel and leisure (100%) and telecommunications (50%) each recorded one company. Of the ten companies that did not disclose information relating to the duties and powers of company shareholders, five were from the basic resources (35.7%) sector. This was followed by companies from banking (33.3%), health care (100%), industrial goods and services (50%), insurance (33.3%) and telecommunications (50%) each recording one company as having not disclosed information relating to the duties and powers of company shareholders. The banking (33.3%), basic resources (7.1%) and insurance (33.3%) sectors each recorded one company as having partly disclosed information relating to the duties and powers of company shareholders.

5.9 COMPANY'S CODE OF ETHICS

5.9.1 Implementation of the code of ethics

FIGURE 5.24 – CODE OF ETHICS

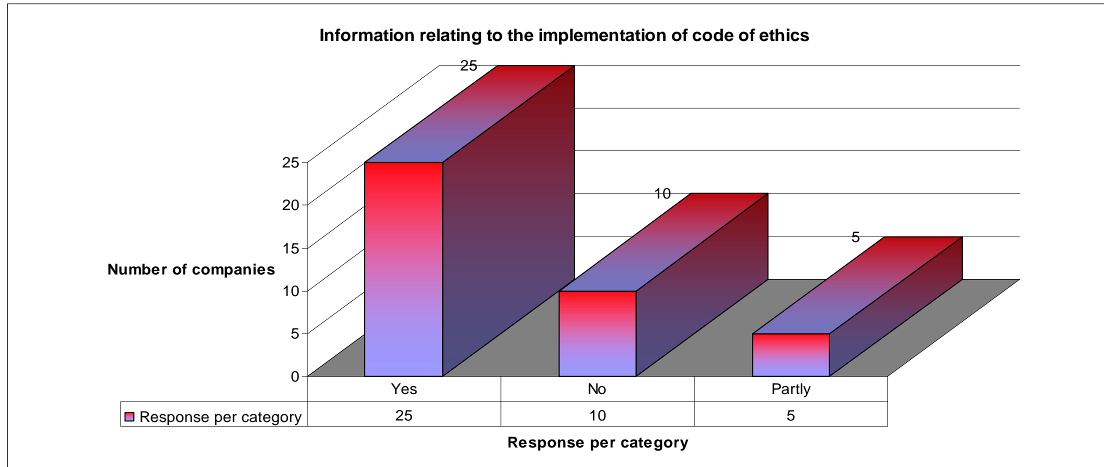


TABLE 5.25 – CODE OF ETHICS

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	1	**33.3**	1	**33.3**	1	**33.3**	3
Basic Resource	8	**57.1**	4	**28.6**	2	**14.3**	14
Construction and Materials	1	**50**	1	**50**	-	-	2
Financial Services	3	**75**	-	-	1	**25**	4
Food and Beverages	1	**50**	-	-	1	**50**	2
Health Care	-	**-**	1	**100**	-	-	1
Industrial Goods and Services	2	**100**	-	-	-	-	2
Insurance	2	**66.7**	1	**33.3**	-	-	3
Media	1	**100**	-	-	-	**-**	1
Oil and Gas	1	**100**	-	-	-	**-**	1
Personal and Household goods	3	**75**	1	**25**	-	**-**	4
Travel and Leisure	1	**100**	-	-	-	**-**	1
Telecommunications	1	**50**	1	**50**	-	**-**	2
Total	25	**62.5**	10	**25**	5	**12.5**	40

- means none

The diagram above reflects the disclosure of companies' codes of ethics in annual reports. According to Figure 5.24, 25 (62.5%) companies fully disclosed their codes of ethics in their annual reports. Companies who fully disclosed this information incorporated a statement on how the code of ethics is carried out, the manner in which the code is implemented and to whom it applies. Figure 5.24 further reveals that ten (25%) companies did not mention the code of ethics in their annual reports, while five companies (12.5%) partly disclosed this information in their annual report. Companies that partly disclosed their codes of ethics mentioned them by name; however, they did not state, for example, how the code is rolled out and how they keep their employees up to date with the code.

Detailed information on the companies' codes of ethics is presented in Table 5.25 above. According to Table 5.25, most companies that fully disclosed information relating to their codes of ethics were from the basic resources (57.1%) sector with eight companies. This was followed by the financial services (75%) and personal and household goods (75%) sectors which both recorded three companies. The insurance (66.7%) and industrial goods and services (100%) sectors both recorded two companies as having fully disclosed their codes of ethics whilst banking (33.3%), construction and materials (50%), media (100%), food and beverages (50%), oil and gas (100%), travel and leisure (100%) and telecommunications (50%) all recorded one company as having fully disclosed its code of ethics in its annual report.

Further to the above, Table 5.25 reveals that four companies from the basic resources (28.6%) sector did not disclose their codes of ethics in their annual reports. The basic services sector is followed by banking (33.3%), construction and materials (50%), health care (100%), insurance (33.3%), personal and household goods (25%) and telecommunications (50%), with each sector recording one company as having not disclosed its code of ethics information in its annual report. Again the basic resources (14.3%) sector recorded two companies as having partly disclosed their codes of ethics in their annual reports followed by the banking (33.3%), financial services (25%) and food and beverages (50%) sectors each with one company.

5.9.2 Whistle blowing

FIGURE 5.25 – WHISTLE BLOWING

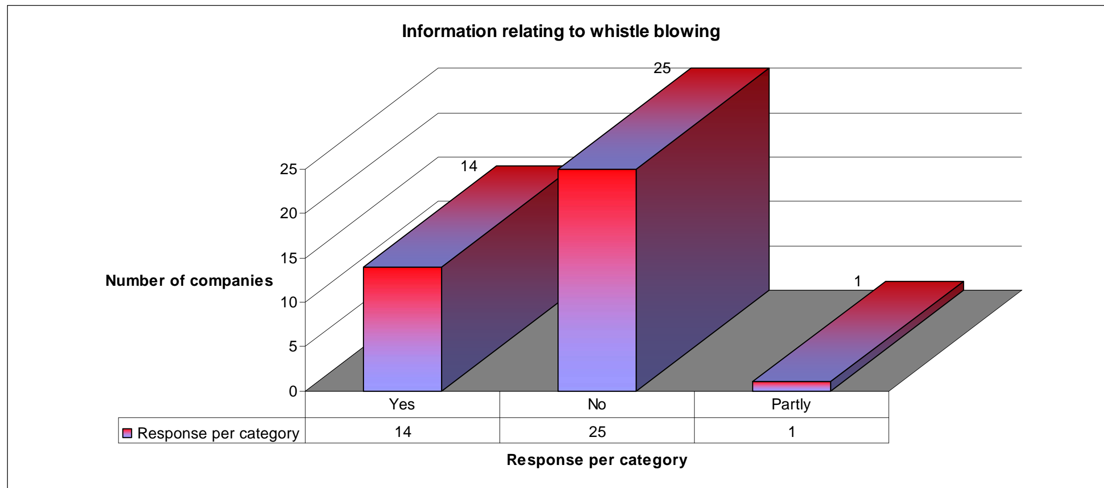


TABLE 5.26 – WHISTLE BLOWING

Supersector	Yes	Yes as a % of total assessed in each sector	No	No as a % of total assessed in each sector	Partly	Partly as a % of total assessed in each sector	Total companies assessed per sector
Banks	-	-	3	**100**	-	-	3
Basic Resources	7	**50**	6	**42.9**	1	**7.1**	14
Construction and Materials	-	-	2	**100**	-	-	2
Financial Services	-	-	4	**100**	-	-	4
Food and Beverages	2	**100**	-	-	-	-	2
Health Care	-	-	1	**100**	-	-	1
Industrial Goods and Services	1	**50**	1	**50**	-	-	2
Insurance	2	**66.7**	1	**33.3**	-	-	3
Media	1	**100**	-	-	-	-	1
Oil and Gas	-	-	1	**100**	-	-	1
Personal and Household Goods	-	-	4	**100**	-	-	4
Travel and Leisure	-	-	1	**100**	-	-	1
Telecommunications	1	**50**	1	**50**	-	-	2
Total	14	**35**	25	**62.5**	1	**2.5**	40

- means none

Figure 5.25 above reflect the disclosure of whistle-blowing information in the annual reports of companies. According to Figure 5.25, 14 (35%) companies fully disclosed their whistle-blowing programmes in their annual report. The information covered by these companies captured amongst other things, the manner in which whistle blowing is carried out, the fraud cases attended to, the number of anonymous tip-offs received, the protection of whistle blowers and the channels used for whistle blowing, i.e. telephone hotlines to report fraud and corruption etc. Figure 5.25 further reveals that 25 (62.5%) companies did not disclose whistle-blowing information at all in their annual reports, while only one (2.5%) company partly disclosed whistle-blowing information. This company reported the existence of a whistle-blowing programme, however, it did not report on matters such as the channels available for reporting fraud and how fraud cases are handled once identified.

Detailed examination of Table 5.26 reveals that of the 14 companies that fully disclosed their whistle-blowing information, seven of these companies were from the basic resources (50%) sector. The basic resources sector was followed by both the insurance (66.7%) and food and beverages (100%) sectors each recording two companies. The industrial goods and services (50%), media (10%) and telecommunications (50%) sectors each recorded one company as having fully disclosed the extent of whistle blowing.

Further analysis of the information relating to whistle-blowing reveals that of the 25 companies (62.5%) that did not disclose whistle blowing in their annual reports, the basic resources (42.9%) sector had six companies that did not disclose, followed by the personal and household goods (100%) and financial services (100%) sectors, both with four companies. The banking (100%) sector had three companies that did not disclose in their annual reports. The construction and materials (100%) sector had two companies that did not disclose information relating to whistle blowing whilst the health care (100%), industrial goods and services (50%), insurance (33.3%)), oil and gas (100%), travel and leisure (100%) and telecommunications (50%) sectors each recorded one company. One company that partly disclosed information relating to whistle blowing was from the basic resources (7.1%) sector.

5.10 CONSOLIDATED RESULTS

FIGURE 5.26 – CONSOLIDATED RESULTS

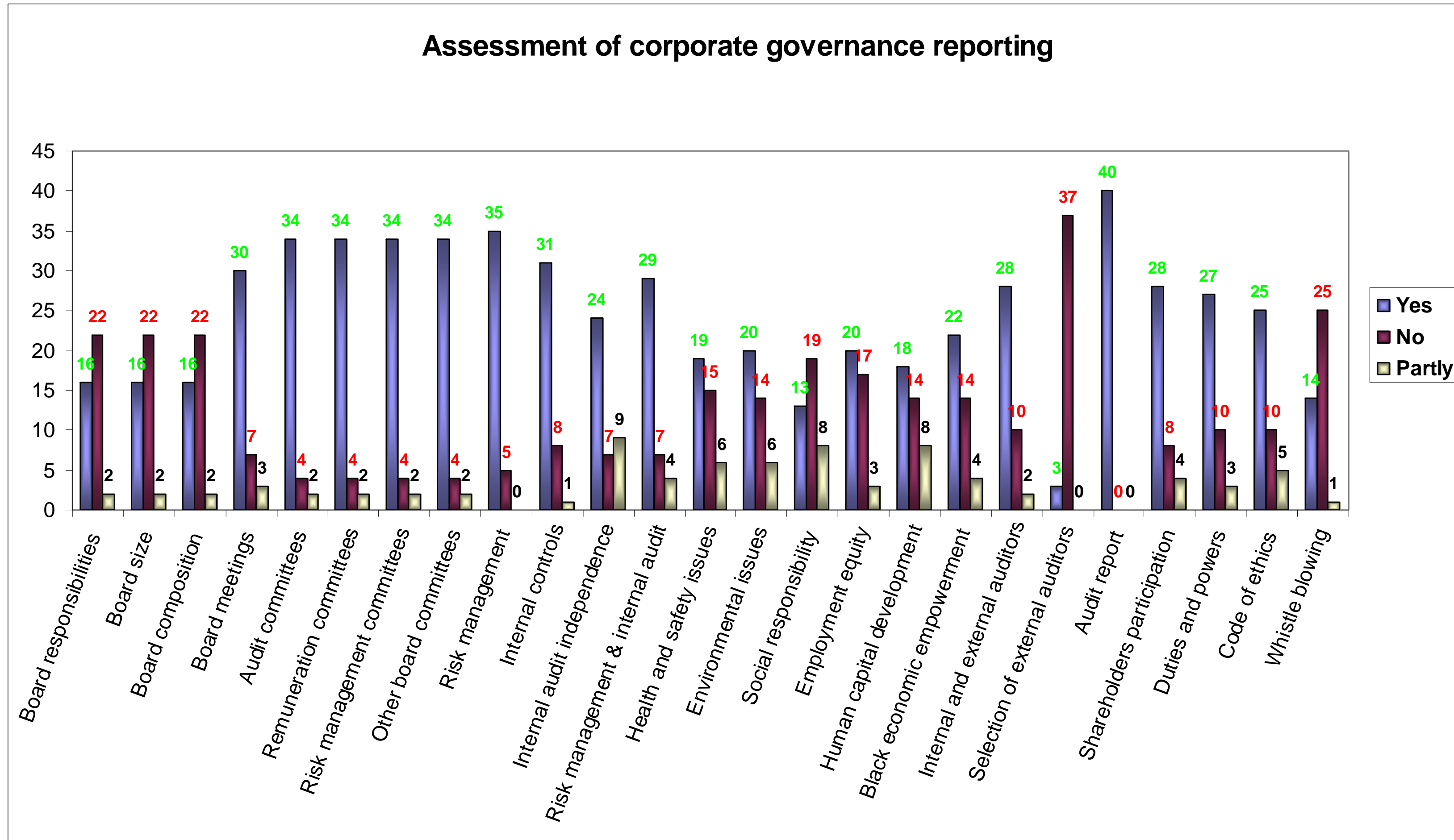


TABLE 5.27 – CONSOLIDATED RESULTS

Category	Yes	Yes as a % of total assessed companies	No	No as a % of total assessed companies	Partly	Partly as a % of total assessed companies	Total Assessed Companies
Board responsibilities	16	**40**	22	**55**	2	**5**	**40**
Board size	16	**40**	22	**55**	2	**5**	**40**
Board composition	16	**40**	22	**55**	2	**5**	**40**
Board meetings	30	**75**	7	**17.5**	3	**7.5**	**40**
Audit committees	34	**85**	4	**10**	2	**5**	**40**
Remuneration committees	34	**85**	4	**10**	2	**5**	**40**
Risk management committees	34	**85**	4	**10**	2	**5**	**40**
Other board committees	34	**85**	4	**10**	2	**5**	**40**
Risk management	35	**87.5**	5	**12.5**	0	**0**	**40**
Internal controls	31	**77.5**	8	**20**	1	**2.5**	**40**
Internal audit independence	24	**60**	7	**17.5**	9	**22.5**	**40**
Risk management & internal audit	29	**72.5**	7	**17.5**	4	**10**	**40**
Health and safety issues	19	**47.5**	15	**37.5**	6	**15**	**40**
Environmental issues	20	**50**	14	**35**	6	**15**	**40**
Social responsibility	13	**32.5**	19	**47.5**	8	**20**	**40**
Employment equity	20	**50**	17	**42.5**	3	**7.5**	**40**
Human capital development	18	**45**	14	**35**	8	**20**	**40**
Black economic empowerment	22	**55**	14	**35**	4	**10**	**40**
Internal and external auditors	28	**70**	10	**25**	2	**5**	**40**
Selection of external auditors	3	**7.5**	37	**92.5**	0	**0**	**40**
Audit report	40	**100**	0	**0**	0	**0**	**40**
Shareholder participation	28	**70**	8	**20**	4	**10**	**40**
Duties and powers	27	**67.5**	10	**25**	3	**7.5**	**40**
Code of ethics	25	**62.5**	10	**25**	5	**12.5**	**40**
Whistle blowing	14	**35**	25	**62.5**	1	**2.5**	**40**

Figure 5.26 and Table 5.27 above reflects the consolidated results of the assessment of corporate reporting in the annual reports of the JSE's top-40 listed companies. A 'yes' in Table 5.27 reflects full disclosure of the required information as per Appendix C, which enhances sound decision making by users. A 'no' reflects no disclosure of corporate governance information in the annual reports, while a 'partly' reflects the partial disclosure of the required information as per Appendix C. Table 5.27 and Figure 5.26 reveal that some of the top-40 listed companies do not fully disclose the required information. The most notable non-disclosures involve the disclosure of information relating to the manner in which external auditors are selected as well as information relating to whistle-blowing programmes. According to Table 5.27, there are only three (7.5%) companies that disclosed the manner in which they selected their external auditors, while 37 (92.5%) companies did not disclose this information.

From Table 5.27, it is clear that a relatively small number of the top-40 JSE listed companies disclosed the information relating to the board responsibilities 16 (40%), board size 16 (40%) and board composition 16 (40%). The other area that reflected low disclosure was the integrated sustainability reporting. In this area, the lowest level of disclosure was seen in the disclosure of social responsibility. There were 13 JSE listed companies (32.5%) that fully reflected their social responsibility in the annual reports. The low disclosure of social responsibility was followed by commitment to human capital development. According to Table 5.27, there were 18 (45%) JSE listed companies that reflected their commitment to human capital development.

Further on the above, Table 5.27 reflects that there were 19 companies (47.5%) that fully disclosed their contribution to the health and safety issues, whilst 20 JSE listed companies (50%) fully disclosed their commitment to environmental issues. These 20 JSE listed companies also fully reflected their employment equity status. Finally, Table 5.27 shows that there were 22 (55%) JSE listed companies that disclosed their BEE status in their annual reports. In interpreting the integrated sustainability reporting, it is important to note that this study was limited to the assessment of the annual reports of the top-40 JSE listed

companies, integrated sustainability disclosures may form part of the other designated reports which do not fall within the ambit of this study

5.11 SUMMARY AND CONCLUSION

Chapter 5 assesses corporate governance reporting in the annual reports of the top-40 South Africa's listed companies. The assessment of corporate governance is based on the company's board and its directors, risk management and internal controls, internal audit, integrated sustainability reporting, accounting and auditing, relations and communication with company shareholders, and information with regards to the company's code of ethics. Qualitative content analysis was used as a technique in the assessment of information in the annual reports.

The top-40 JSE companies that were assessed were from the basic resources supersector with 14 companies, followed by the personal and household goods, and financial services sectors, both with four companies, followed by the banking and insurance supersectors each with three companies, then by construction and materials, food and beverages, industrial goods and services and telecommunications all with two companies each. The healthcare, media, oil and gas, and travel and leisure supersectors each had one company (refer to Table 5.1 in section 5.2).

The information assessed revealed that some of the top-40 JSE listed companies did not fully disclose the minimum required corporate governance statements in their annual reports as per the requirements outlined in Appendix C. The most notable categories that were not disclosed by most companies were the whistle-blowing programmes and the selection of external auditors. According to the information analysed above in Figure 5.27 (refer to section 5.10), only 14 (35%) companies fully disclosed their whistle-blowing information in their annual reports and 25 (62.5%) companies did not mention whistle-blowing programmes whilst one company partly disclosed this information. The prevalent non-disclosure of the selection of external auditor and the whistle blowing information lessen the usefulness of those annual reports that did not disclose, particularly to the users

of annual reports who are concerned about fraud and extent of the external audit independence in companies.

With regards to the selection of external auditors, Figure 5.27 above revealed that almost all companies did not report on the appointment of external auditors in their annual reports. The information analysed revealed that 37 companies (92.5%) did not disclose information relating to the appointment of the external auditors in their annual reports. There is no annual report that partly captures the appointment of external auditors. There were three companies (7.5%) that reported the appointment of their external auditors. Section 27 (sec. 271 (4)) of the Corporate Laws Amendment Act, 2006 (RSA 2006: sec. 27 (sec. 271 (4))) state that in case of a widely held company with an audit committee, an appointment of the auditor by directors shall only be valid if the audit committee is satisfied that the auditor is independent of the company.

Further on the above, section 30 (sec. 274A (1)) state that the same individual may not serve as an auditor or designated auditor of a widely held company for more than five consecutive years. If an individual has served as an auditor or the designated auditor of a company for two or more consecutive years and then ceases to be an auditor or designated auditor of the company concerned, that particular individual may not be appointed as an auditor or designated auditor of that company until after at least two further financial years (RSA 2006: sec. 32 (sec. 275A (1))). Based on the above provisions of the Corporate Laws Amendment Act, 2006, it is anticipated that in future there might be an increased disclosure of the information relating to the external auditors in the annual reports of companies, which will enhance the decision making of users of annual reports.

All the top-40 JSE listed companies (100%) attached the audit reports in their annual reports. This could be attributed to the statutory duty of an external auditor (RSA 1973: sec. 301) which requires the external auditor to report to the members of a company that the annual financial statements of that company was audited and whether they fairly present the financial position of the company and the results of its operations in the manner required by the Act.

The assessment of corporate governance disclosures in the annual reports of the top-40 listed companies using qualitative content analysis as a method of coding the annual reports is limited to the annual reports of the top-40 JSE listed companies. Therefore, the information for example, relating to the sustainability reporting could have been reported in the other reports that did not form part of this study but are hosted on the companies' websites. The assessed information was tabulated and graphically presented. The Chapter to follow will provide the summary, conclusions, and recommendations of the study and areas for further research.

CHAPTER 6

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

6.1 INTRODUCTION

The main objective of this research study was to assess whether corporate governance reporting in the annual reports of the JSE's top-40 listed companies provide useful information for users' decision making. To address this objective, the recommendations of the King II report (IOD 2002) and the requirements of the Corporate Laws Amendment Act, 2006 (RSA 2006) were considered. A checklist, based on the King II report (IOD 2002) and the Corporate Laws Amendment Act, 2006 (RSA 2006), was compiled. A comprehensive annual reports assessment of the usefulness of the disclosure of corporate governance statements by the JSE's top-40 listed companies was conducted using the content analysis methodology.

Chapter 6 revisits the research problem statement formulated in Chapter 1 and summarises the research findings of the literature review and the empirical evidence collected. Conclusions are drawn on the basis of the research results. Recommendations are made on how to improve the disclosure of corporate governance statements in annual reports. The Chapter concludes with a discussion of possible areas for further research.

6.2 SUMMARY OF THE RESEARCH STUDY

The literature review in Chapters 2 to 5 is summarised below and the conclusions for each Chapter presented in section 6.3 below.

Chapter 2 discussed the agency theory. The agency relationship was defined as one that emanates from the owner's inability to run the company on a day-to-day basis. In the

discussion of agency theory, two agency relationships emerged, namely the manager-shareholder relationship and the shareholder-debtholder relationship. The Chapter indicated how agency conflicts arise, say, when the principal and the agent have different interests. Jensen and Meckling (1976) described the costs of monitoring the agent as exorbitant. The agency theory thus provided a theoretical framework of corporate governance by explaining the problems caused by the separation of ownership to control, which is the basic corporate governance problem.

The Chapter went on to explore the development of corporate governance in Germany, the UK, the US and South Africa. Germany, the UK the US were preferred because they are three of the major trading partners of South Africa. The discussion of historical developments established that the evolution of corporate governance in Germany was promoted by efforts to improve the European single market for financial services and products, while in the UK, investors' activism ensured that pyramid firms were disbanded because they argued that pyramids were fundamentally risky businesses and encouraged insider trading.

In the USA, the evolution of corporate governance was based on events such as the 1929 Wall Street Crash, the massive bankruptcies of Enron and WorldCom and the small corporate debacles of companies such as AOL, Tyco, Aldephia Communications and Global Crossing. Compared with developments in the above countries, the evolution of corporate governance in South Africa was a result of the volatile political situation that arose after the suspension of South Africa from the Commonwealth countries because of the country's racial policies of the time. This suspension left South African firms behind in the world's corporate governance restructuring.

Recent corporate governance practices in these countries were spearheaded by the need to promote higher standards of ethical conduct in companies and a range of legislation and codes of good corporate governance that promote accountability and transparency in the use of shareholders' capital. This legislation includes, the Sarbanes-Oxley Act of 2002 in the US; the German Corporate Governance Code in Germany; the King II report and the

Corporate Laws Amendment Act of 2006 in South Africa; and the Cadbury report of 1992, the Greenbury Report of 1995, the Hampel Report of 1998, the Turnbull Report of 1999 and the Higgs Review of 2003 in the UK.

Chapter 3 examined the corporate governance framework in South Africa. The South African corporate governance framework was placed in context by discussing the corporate sins, the requirements of the King reports on corporate governance (IOD 1999 & 2002), the Corporate Laws Amendment Act, 2006 (RSA 2006) and the JSE listings requirements (JSE 2003). The Chapter concluded that any manager who is sluggish, greedy and fearful and who promotes his/her interests above the interest of the company is guilty of corporate sins. In order to place the Corporate Laws Amendment Act, 2006 (RSA 2006) in context, Chapter 3 noted that the Companies Act, 1973 (RSA 1973) has been in existence for more than 30 years. The Chapter commented further that this Act, 1973 (RSA 1973) has already been amended a number of times. However, despite these amendments, the basic principles that established the accountability arrangements between the providers (principals) and stewards (agents) of capital have essentially remained unchanged.

Chapter 3 also found that the Companies Act, 1973 was not designed to support the openness, transparency, fairness and accountability principles, which the King I report (IOD 1994) addressed. The Companies Act, 1973, therefore had to be updated to accommodate the recommendations of the King I and the King II reports (IOD 1999 & 2002). The amendment led to promulgation of the recent Corporate Laws Amendment Act, 2006 (RSA 2006). The most notable changes included in the Corporate Laws Amendment Act, 2006 (RSA 2006) are as follows: the identification of companies; circumstances in which a company may provide financial assistance for the purchase of its own shares; the disposal of the undertaking or the greater part of its assets; audit committees for public interest companies; new obligations on companies and auditors in order to promote the independence of auditors; and the legal backing of the accounting standards currently used for financial reporting.

The discussion in Chapter 4 provided the theoretical basis of the research instrument used in this study. A checklist to be used to assess the annual reports of the JSE's top-40 listed companies was formulated and discussed. This checklist was based on the requirements of the King II report (IOD 2002) and the provisions of the Corporate Laws Amendment Act, 2006 (RSA 2006). The following seven specific areas were identified and included in the checklist: the board and its directors, risk management and internal controls, internal audit, integrated sustainability reporting, accounting and auditing, relation and communication with company shareholders and the company's code of ethics.

In order to determine the amount and the quality of information disclosed in each of the above specific areas and decide whether a company has fully disclosed, not disclosed or partly disclosed the required corporate governance information in its annual report, the empirical method known as content analysis was used, and outlined in Chapter 4. The Chapter noted the following two limitations of content analysis methodology as identified by Unerman (1999): Firstly, studies focusing exclusively on annual reports risk capturing an incomplete picture on the information disclosed, and hence an incomplete picture of the practices they are attempting to study. Secondly, any content analysis study adopting measurement techniques that capture only words and numbers and ignore pictures, graphics and different typeface sizes, is also likely to result in incomplete representation.

In conclusion, Chapter 5 assessed the usefulness of the disclosure of corporate governance statements in the annual reports of the JSE's top-40 listed companies using the content analysis methodology. The results obtained in using word and meaning content analysis were benchmarked against the requirements of the King II report and of the Corporate Laws Amendment Act, 2006, to assess whether the selected companies fully disclosed, partly disclosed or did not disclose the required information. Complete information enhances sound decision making by users, while in the event of incomplete or partly complete information, stakeholders and potential stakeholders will not be able to make sound judgements.

The principal finding on full disclosure was reflected by 100% disclosure of the audit reports in the annual reports of the JSE's top-40 listed companies which could be attributed to the statutory duty of an external auditor (RSA 1973: sec. 301). This duty requires the external auditor to report to the members of a company that the annual financial statements of that company were audited and whether they fairly present the company's financial position and the results of its operations in the manner required by the Act. During the assessment of the JSE's top-40 listed companies' annual reports, it appeared that the information relating to whistle blowing, the selection of the external auditor and sustainability reporting were commonly not disclosed at all by some of the JSE's top-40 listed companies.

The partial disclosure of information was also observed, especially in areas such as the information relating to internal audit independence, social responsibility and human capital development issues. Regarding the information on these corporate governance areas that appeared in the annual reports on, say, social responsibility, companies mentioned that they have social responsibility programmes, but they failed to disclose information such as how much was spent on these programmes and they did not identify the programmes. On the human capital development side, these companies noted the importance of human capital development – however, there was no indication of how many employees underwent training and how much was actually spent on developing skills.

Further examination of the assessed information revealed that there is a practice of informing users of annual reports about the activities and responsibilities of board committees, risk management, adequacy of internal controls, the company's code of ethics, shareholders' participation, the duties and powers of shareholders as well as the relationship between risk management and internal controls by the JSE's top-40 listed companies. This is reflected in a high disclosure of this information by the JSE's top-40 listed companies in their annual reports.

6.3 CONCLUSIONS

The main objective of this research study was to assess the usefulness of corporate governance reporting in the annual reports of the JSE's top-40 listed companies. The research was conducted by means of a literature review and an empirical study. The literature review and the empirical study highlighted the state of corporate governance disclosures in the annual reports of the JSE's top-40 listed companies.

The research study indicated that the majority of these companies adhere to good corporate governance disclosure practices which advance the usefulness of information in users' decision making. The study also noted that these companies reflected high levels of disclosure of corporate governance statements in their annual reports, particularly in areas such as information relating to the activities and responsibilities of board committees, risk management, the adequacy of internal controls, the company's code of ethics, shareholder participation, the duties and powers of shareholders and the relationship between risk management and internal controls. The high levels of disclosure of this information signify the practice of the JSE's top-40 listed companies of informing users of the annual reports about these activities.

The study also noted that certain areas of disclosure require improvement. These areas reflected low levels of disclosure of corporate governance statements in the annual reports of the JSE's top-40 listed companies, which could hinder users' decision making. The low levels of disclosure of corporate governance statements in the annual reports of the JSE's top-40 listed companies were prevalent in the areas of social responsibility, the selection of an external auditor and whistle blowing.

6.4 RECOMMENDATIONS

In light of the above summary and conclusions, it is apparent that the disclosure of corporate governance statements in the annual report add much value if valuable information is provided to assist users' decision making. The main recommendations arising from this research study are discussed below.

6.4.1 Balance between comprehensive, reliable and relevant information

This research study revealed that the information disclosed as corporate governance statements in the annual report should be reliable and relevant to enable users and stakeholders or potential stakeholders to make informed decision on the basis of the information. It is recommended that the relevant and reliable corporate governance information disclosed in the annual report of a company should also be comprehensive. Management of a company should strike a balance between what they deem relevant and reliable disclosure as well as what they consider to be unnecessary disclosure in the decision making of users.

6.4.2 Timeline on the explanation given

If a company cannot fully disclose the required information, as advocated by the IOD (2002) in its "comply or explain" approach, it should provide an explanation of non-disclosure of the required information. On the basis of this, it is recommended that such an explanation should include a statement by the management of a company committing themselves to corporate governance adherence and explaining their plan to address this in future. A timeline could be set, which provides information on future dates when the management of a company intend addressing such shortcomings. This should remove any uncertainties because users, stakeholders and potential stakeholders will not have to guess the reasons for non-disclosure, and will be informed of the future dates on which such shortcomings will be addressed.

6.4.3 Foreseeable role of audit committees in the disclosure of the external auditor's activities

During the assessment of annual reports, there was notable non-disclosure of information, particularly information relating to the selection of an external auditor in which 37 (92.5%) JSE-listed top-40 companies failed to disclose this information in their annual reports. The Corporate Laws Amendment Act, 2006, has amplified the role of the audit committee in a company. The provisions of the Corporate Laws Amendment Act, 2006, strengthen the role of audit committees. Section 27 (sec. 271 (4)) states that the appointment of the auditor by the directors will only be valid if the audit committee is satisfied that the auditor is independent of the company. It is recommended that such information on the external auditor should be disclosed in the section in the annual report dealing with the responsibilities/activities of the audit committee. This would increase the usefulness of the disclosure of information relating to external auditors.

6.4.4 Development of whistle blowing disclosure guidelines and whistle blowing reports

The empirical evidence revealed that 25 (62.5%) top-40 JSE listed companies failed to disclose the information relating to whistle blowing in their annual reports. The prevalent non-disclosure of whistle blowing information in the annual reports of these companies reflects a need to develop guidelines on how whistle blowing information can be disclosed in annual reports. It is also necessary to note that most companies have anonymous communication facilities to report fraudulent activities. If fraudulent activities in the company are reported, internal auditors or other relevant structures investigate the matter and report subsequently. In order to enhance the usefulness of whistle blowing disclosures, it is recommended that information dealing with, for instance, the number of cases lodged, the number of cases investigated, the number of cases outstanding and finalised, and the financial implications of these cases, is disclosed in the company's annual reports. In addition, if the annual report is loaded on the website, it is further recommended that it should contain links to summaries or information on the whistle blowing reports.

6.4.5 Using the annual report in conjunction with the sustainability reports and websites

The non-disclosure of information was also observed in the information relating to sustainability reporting. However, the non-disclosure of sustainability information was not as prevalent as that reflected by the non-disclosure of the information relating to the selection of the external auditor and the information on whistle blowing. As mentioned in the limitations, this study was confined to the assessment of corporate governance statement disclosures in the annual reports. It is worth noting that sustainability reports may be disclosed in the designated reports, which does not necessarily form part of companies' annual reports. It is recommended that these sustainability reports should be read or analysed in conjunction with the annual reports. A clear reference to such sustainability reports should be included in a company's annual report. In addition, if the annual report is hosted on the website, it is further recommended that it should contain links to these sustainability reports.

The final recommendation emanates from the fact that this research assessed the disclosure of minimum corporate governance information on annual reports. Justification for use of the annual report was that a company that is committed to promoting and maintaining good corporate governance should use its annual report to communicate this to its shareholders and to the public in general. With improved technology, companies now use Securities Exchange News Service (SENS) announcements, press releases, trading updates and cautionary announcements as well as their websites to communicate the information to their stakeholders. It is recommended that the annual report should be read or assessed in conjunction with the corresponding information on the website and other reports that are being analysed. This will also assist in cases where the information on the website and other forms of communications has been updated but not been communicated to the holders of the annual reports previously dispatched.

6.5 LIMITATIONS OF THE RESEARCH

Certain limitations in this research that might have prevented the researcher from giving the full picture of the state of corporate governance disclosures in South Africa's JSE-listed top-40 companies were discussed in section 1.7. These include the use of annual reports only in the process of assessing corporate governance disclosures and the limited discussion of the Companies Bill, 2007.

6.6 AREAS FOR FURTHER RESEARCH

6.6.1 Sectoral corporate governance disclosures

This research assessed the JSE's top-40 listed companies. Possible future studies could consider listed companies according to the sectors identified in Appendix D, to ascertain the disclosure of corporate governance information in the annual report of all listed companies in their respective sectors.

6.6.2 Consideration of other reports and company websites

The results obtained indicate that the majority of the JSE's top-40 listed companies in South Africa adhere to good corporate governance disclosure practices. However, there are areas in which the non-disclosure of information was prevalent. These include the disclosure of information on the selection of external auditors and whistle blowing. Future research, employing sources such as SENS announcements, press releases, trading updates, cautionary announcements and companies' websites in conjunction with the companies' annual reports should be conducted in these two areas to ascertain the level of disclosure of this information by the JSE's top-40 listed companies.

6.6.3 The anticipated Companies Act and the King III Report

It would seem as if the expected Companies Act and the King III report on corporate governance will seek increased disclosure requirements. Both the new Companies Act, expected in 2010, and the King III report expected in 2009 should form part of any future assessment of corporate governance disclosures.

APPENDIX A – QUESTIONS ON THE CHECKLIST USED IN THE ASSESSMENT OF CORPORATE GOVERNANCE REPORTING

NAME OF THE COMPANY

1. BOARD AND ITS DIRECTORS

1.1 Charter

1.1.1 Does the annual report of the company contain a charter that clearly sets out the responsibilities of the board?

Yes	No	Partly

1.1.2 Does the annual report of the company contain the board size?

Yes	No	Partly

1.1.3 Does the annual report of the company contain the board composition?

Yes	No	Partly

1.2 Meetings

1.2.1 Does the annual report contain the number of meetings held by the board of directors?

Yes	No	Partly

1.3 Board committees

1.3.1 Does the annual report of the company contain information relating to the audit committee?

Yes	No	Partly

1.3.2 Does the annual report of the company contain information relating to the remuneration committee?

Yes	No	Partly

1.3.3 Does the annual report of the company contain information relating to the risk management committee?

Yes	No	Partly

1.3.4 Does the annual report of the company contain information relating to the other board committees?

Yes	No	Partly

2. RISK MANAGEMENT AND INTERNAL CONTROL

2.1 Does the annual report of the company contain the most important risk management information (i.e. the headline risk areas and risk mitigating strategies)?

Yes	No	Partly

2.2 Does the annual report contain the statement of internal controls issued by the directors and endorsed by the board of directors?

Yes	No	Partly

3. INTERNAL AUDIT

3.1 Does the information regarding the independence and objectivity of the internal audit function appear on the annual report of the company?

Yes	No	Partly

3.2 Does the annual report capture the information regarding the relationship between the risk management unit and internal audit unit?

Yes	No	Partly

4. INTEGRATED SUSTAINABILITY REPORTING

4.1 Does the annual report of the company contain information regarding health and safety issues?

Yes	No	Partly

4.2. Does the annual report of the company contain information regarding environmental reporting?

Yes	No	Partly

4.3 Does the annual report of the company contain information regarding social investment spending?

Yes	No	Partly

4.4 Does the annual report of the company contain information regarding employment equity?

Yes	No	Partly

4.5 Does the annual report of the company contain information regarding human capital development?

Yes	No	Partly

4.6 Does the annual report of the company contain information regarding black economic empowerment?

Yes	No	Partly

5. ACCOUNTING AND AUDITING

5.1 Does the annual report reflect the information relating to the relationship between internal and external auditors?

Yes	No	Partly

5.2 Does the annual report reflect the information relating to the manner in which the external auditor was selected?

Yes	No	Partly

5.3 Does the annual report contain the audit report with audit opinion (i.e. the proof of audit report part of the annual report)?

Yes	No	Partly

6. RELATIONS AND COMMUNICATION WITH COMPANY SHAREHOLDERS

6.1 Does the annual report of the company contain information regarding the shareholders' participation in its activities?

Yes	No	Partly

6.2 Does the annual report of the company contain information clearly outlining the duties and powers of the company shareholders?

Yes	No	Partly

7. COMPANY'S CODE OF ETHICS

7.1 Has the company implemented a code of ethics that commits it to the highest standards of ethical behaviour, that involves all company stakeholders and that is clear on the behaviour expected from all its employees?

Yes	No	Partly

7.2 Does the company have communication channels for whistle blowers e.g. anonymous emails and telephone lines?

Yes	No	Partly

APPENDIX B – SAMPLE SPREADSHEET USED TO ANALYSE THE SELECTED TOP-40 JOHANNESBURG SECURITIES EXCHANGE (JSE) LISTED COMPANIES

Below is a spreadsheet used to analyse information on the listed companies as well as the company names. The information used is publicly available in the annual report of each and every company and on each and every company's website. The results of the analysis can be found in Chapter 5 of this dissertation.

Example – information relating to the board charter				
Name of a company	**Supersector**	**Yes**	**No**	**Partly**
ABSA (ASA)[1]	Banks			
AFRICAN RAINBOW (ARI)	Basic Resources			
ANGLO (AGL)	Basic Resources			
ANGLOGOLD ASHANTI (ANG)	Basic Resources			
ANGLOPLAT (AMS)	Basic Resources			
ARCELORMITTAL (ACL)	Basic Resources			
BARWORLD (BAW)	Industrial Goods & Services			
BHPBILL (BIL)	Basic Resources			
BIDVEST (BVT)	Industrial Goods & Services			
EXXARO (EXX)	Basic Resources			
FIRSTRAND (FSR)	Financial Services			
GFIELDS (GFI)	Basic Resources			
HARMONY (HAR)	Basic Resources			
IMPALA PLATINUM (IMP)	Basic Resources			
IMPERIAL (IPL)	Travel & Leisure			
INVESTEC LTD (INL)	Financial Services			
INVESTEC PLC (INP)	Financial Services			
KUMBA IRON ORE (KIO)	Basic Resources			
LIBERTY (LGL)	Insurance			
LONMIN (LON)	Basic Resources			

1. In brackets is the company's code used by the Johannesburg Securities Exchange (JSE) e.g. for Kumba Iron Ore the code is (KIO).

Example – information relating to the board charter

M&R HOLD (MUR)[1]	Construction & Materials			
MONDILTD (MND)	Basic Resources			
MTN GROUP (MTN)	Telecommunications			
NASPERS -N (NPN)	Media			
NEDBANK (NED)	Banks			
NETCARE (NTC)	Health Care			
OLD MUTUAL PLC (OML)	Insurance			
PPC (PPC)	Construction & Materials			
REMGRO (REM)	Personal & Household Goods			
RICHEMONT (RCH)	Personal & Household Goods			
RMB HOLDINGS (RMH)	Financial Services			
SAB (SAB)	Food & Beverages			
SANLAM (SLM)	Insurance			
SAPPI (SAP)	Basic Resources			
SASOL (SOL)	Oil & Gas			
STANBANK (SBK)	Banks			
STEINHOFF (SHF)	Personal & Household Goods			
TELKOM (TKG)	Telecommunications			
TIGERBRANDS (TBS)	Food & Beverages			
WOOLIES (WHL)	Personal & Household Goods			
Total				

1. In brackets is the company's code used by the Johannesburg Securities Exchange (JSE) e.g. for Kumba Iron Ore the code is (KIO).

APPENDIX C – REQUIREMENTS OF THE KING II REPORT ON CORPORATE GOVERNANCE AND THE CORPORATE LAWS AMENDMENT ACT, 2006

1. Board and its directors			
Number of categories majored (sub-categories)	***Key word/s***	***King II requirement***	***Corporate Laws Amendment Act, 2006 requirement***
• Charter o Board responsibilities	Responsibilities, tasks, obligations, jobs, function, requirements, roles and commitment.	• Companies should be headed by an effective board of directors with sufficient capacity to lead and control the company. The board is a focal point of the corporate governance system and is ultimately responsible for the performance and the affairs of the company. • The board should comprise the balance of executive and non-executive directors, preferable with the majority of non-executive directors; most of them should be independent from management for minority interests to be protected. King II report distinguishes between executive, non-executive, independent and shadow directors. Independent director is defines as a non-executive who has no other relationship with the company except that of directorship. • The King II report is silent on the size of the	The Corporate Laws Amendment Act, 2006 did not address board responsibilities per se, although (Sec 9) Sec 38 (2A) (i) (ii) and (Sec24) Sec 269A (1) expand on existing board responsibilities: • Section 9 (2A) (i) (ii) (sec. 38) does not prohibit a company from giving financial assistance for the purchase of or subscription for shares of that company or its holding company, if the company's board is satisfied that: (i) Subsequent to the transaction, the consolidated assets of the company fairly valued will be more than its consolidated liabilities; and (ii) Subsequent to providing the assistance, and for the duration of the transaction, the company will be able to pay its debts as they become due in the ordinary course of
• Charter o Board size	Size, dimension, scope, number and extent.		
• Charter o Board composition	Composition, executive, non-executive, independent non-executive.		

		board, except noting that every board should consider whether its size, diversity and demographic composition make it effective. • The board should develop a charter setting out its responsibilities, which should be disclosed in its annual report. • The board should give the strategic direction to the company, appoint the CEO and ensure that there is a succession planning for key positions in a company. • The board should ensure that the company complies with all relevant laws, codes and regulations of business practices. • The board should establish the code of conduct addressing conflict of interests.	business. • Section 24 (sec. 269A (1)) requires that every financial year in which a company is a widely held company, its board of directors shall appoint an audit committee for the following financial year. • The Corporate Laws Amendment Act, 2006 is silent on the board size and its composition.

1. Board and its directors			
Number of categories majored (sub-categories)	***Key word/s***	***King II requirement***	***Corporate Laws Amendment Act, 2006 requirement***
• Meetings	Details of attendance, meetings, attendance of meetings, availability of executive directors, availability of non-executive directors, availability of independent non-executive directors, absence on meetings	• The board should meet regularly, at least once a quarter if not more frequently as circumstance require. They should also disclose in the annual report the number of meetings each year and the details of attendance of each director at such meetings.	• The Corporate Laws Amendment Act, 2006 is silent on the how meetings should be dealt with/conducted.
• Board committees o Audit committee	Audit committee, audit sub-committee, board audit committee.	• Each board should have at least an audit and a remuneration committee. The audit committee should have at least two independent non-executive directors. The majority of members of the audit committee should be financially literate. • The committee should be chaired by the independent non-executive director who is not the chairman.	• Section 24 (3) (sec. 269A (3)) of the Corporate Laws Amendment Act, 2006 requires that an audit committee of a widely held company must have at least two members and consist only of non-executive directors of the company who must act independently • Section 26 (sec. 270A) requires the audit committee of a widely held company must do the following with respect to the financial year for which it is appointed:

<table>
<tr>
<td>• Board committees
o Remuneration committee</td>
<td>Remuneration committee, remuneration sub-committee, board remuneration committee.</td>
<td rowspan="3">• The audit committee should have the written terms of reference, which deals with its membership, authority and duties.
• There should be a formal procedure for certain functions of the board to be delegated to the board committees, describing the extent of the delegation to enable the board to properly discharge and responsibilities and to effectively fulfil its decision taking process. Committee composition, a brief description of its remit, the number of meetings held and other relevant information should be disclosed in the annual report.
• The chairmen of the board committees, particularly those of audit, remuneration and nomination committees should attend the company’s AGM.</td>
<td rowspan="3">(a) Nominate for appointment as auditor of the company under section 26 (sec. 270) a registered auditor who, in the opinion of the audit committee, is independent of the company;

(b) Determine the fees to be paid to the auditor and the auditor's terms of engagement;

(c) Ensure that the appointment of the auditor complies with this Act and any other legislation relating to the appointment of auditors;

(d) Determine the nature and extent of any non-audit services which the auditor may provide to the company;

(e) Pre-approve any proposed contract with the auditor for the provision of non-audit services to the company;

(f) Insert in the financial statements to be issued in respect of that financial year a report—

(i) Describing how the audit committee carried out its functions;
(ii) Stating whether the audit committee is satisfied that the auditor was independent of the company;

(g) Receive and deal appropriately with any complaints (whether from within or outside the company) relating either to the accounting practices and internal audit of the company or to the content or auditing of its financial statements, or to any related matter; and</td>
</tr>
<tr>
<td>• Board committees
o Risk management committee</td>
<td>Risk management committee, risk sub-committee, board risk committee.</td>
</tr>
<tr>
<td>• Board committees
o Other committees</td>
<td>Nomination committee, safety and sustainable development committee, finance committee, director affairs committee, credit committee, implementation committee, audit and corporate governance committee, employment equity & development committee, executive committee, investment committee, market development committee, political donations committee, assets and liability committee and the</td>
</tr>
</table>

	tender committee.		*(h)* Perform other functions determined by the board. • Section 26 (sec. 270A (2)) According to this section, nothing in this section precludes the appointment by a widely held company at its annual general meeting of an auditor other than one nominated by the audit committee, and where such an auditor is to be appointed section 26 (sec. 270A (1) (a)) shall not apply, but the appointment shall not be valid unless the audit committee is satisfied that the proposed auditor is independent of the company. • Section 26 (sec. 270A (3)) state that the appointment of an audit committee shall not reduce the functions of the board of directors of the company except with respect to the appointment, fees and terms of engagement of the auditor. • Section 26 (sec. 270A (4)) state that a widely held company shall meet all expenses reasonably incurred by its audit committee, including the fees of any consultant or specialist engaged by the audit committee to assist it in the performance of its duties. • The Corporate Laws Amendment Act, 2006 is silent on the matters relating to the other board committees.

2. Risk management and internal controls			
Number of categories majored (sub-categories)	***Key word/s***	***King II requirement***	***Corporate Laws Amendment Act, 2006 requirement***
• Risk management information i.e. headline risk areas	Risk, risk management, headline risk areas, risk areas, identified risk, ongoing risk, threats, hazards, exposures.	• The board is responsible for the total process of risk management, whilst management remain accountable to the board for designing, implementing and monitoring the process of risk management and integrating it into its day to day activities. • The board must decide the company's risk appetite and tolerance; they should also set the risk strategy in liaison with executive directors and senior managers. These policies should be clearly communicated to all employees to ensure that the risk strategy is incorporated into the language and the culture of a company. • The board must ensure that the assessment of the processes and outcome of the key risks is undertaken annually in and that the important risk management information is disclosed annually in the company's annual report or to the shareholders at the AGM. • Risks should be assessed on an ongoing basis and control activities should be designed to respond to risks throughout the company.	• The Corporate Laws Amendment Act, 2006 did not pronounce on the matters relating to risk management and internal controls.
• Internal control adequacy	Controls, internal controls, control, internal control, directions, frameworks, adequacy of internal control, governance, assurance, guarantee.		

3. Internal Audit			
Number of categories majored (sub-categories)	***Key word/s***	***King II requirement***	***Corporate Laws Amendment Act, 2006 requirement***
• Internal audit independence	Internal audit, internal audit independence, independence, internal audit autonomy, autonomy, duties of internal audit, audit committee.	• Companies should have an effective internal audit function that has the respect and co-operation of both the board and management. The purpose, authority and responsibility of the internal audit activity should be formally defined, and the internal auditor should report at a level within the company that allows him to accomplish his/her responsibilities fully. • If the internal and external audit functions are carried out by the same accounting firm, independence of the two activities must be ensured. • The head of the internal audit function should report at the audit committee meetings, and have unrestricted access to the chairman of the company, particularly when the position of chairman is held by a non-executive director as well as the chairman of the audit committee.	• The Corporate Laws Amendment Act, 2006 did not pronounce on the matters relating to internal audit, with the exception of section 26 (sec. 270A (1) (g)) which states that an audit committee of a widely held company must receive and deal appropriately with any complaints (whether inside or outside the company) relating to internal audit.
• Relationship between risk management unit and internal audit unit	Risk management and internal audit, relationship between risk management, audit committee, risk management committee and internal audit.		

4. Integrated sustainability reporting			
Number of categories majored (sub-categories)	***Key word/s***	***King II requirement***	***Corporate Laws Amendment Act, 2006 requirement***
• Health and safety issues	SHE (safety, health and environment), SHEQ (safety, health, environment and quality), health, safety, wellbeing, security, sustainability reporting, Global Reporting Initiative (GRI), employee health, employee safety, diseases, HIV/AIDS.	• Companies should report at least annually on the nature and the extent of their social, transformation, ethical, safety, health and environmental management policies and practices. • Criteria and guidelines for materiality should be developed by each company to help it report consistently. Regard should be given to international models and guidelines. • Companies should involve stakeholders in determining standards of ethical behaviour and should the extent of adherence to the code. • Matters which should be specifically addressed are health and safety issues, the impact of HIV/AIDS and strategies to minimise its impact on the company, environmental reporting, social investment spending, employment equity, human capital development issues and the black economic empowerment.	• The Corporate Laws Amendment Act, 2006 did not pronounce on the matters relating to the integrated sustainability reporting.
• Environmental issues	Sustainability reporting, SHE, SHEQ, environment, environmental safety, safety and environment.		
• Social investment spending	Community, corporate citizen, social spending, social, social investment, social responsibility.		
• Employment equity	Affirmative Action, AA, EE, Employment Equity, equality, fairness, equal opportunities, impartiality.		

• Human capital development	Training, human capital, human development, development, human assets, employee training, people.		
• Black economic empowerment	Black ownership, Black Empowerment, BEE transactions, BEE, Black Economic Empowerment, Empowerment transactions, Broad Based Black Economic Empowerment, Broad Based Socio Economic Empowerment.		

5. Accounting and auditing

Number of categories majored (sub-categories)	*Key word/s*	*King II requirement*	*Corporate Laws Amendment Act, 2006 requirement*
• Interactions between internal and external auditors	Audit committee, relation between internal and external auditors, duties of external auditors, duties of internal auditors, interaction between internal and external auditors, communication between internal and external auditors, dealings between internal and external auditors, connections between internal and external auditors.	• Companies should aim for efficient audit processes using external auditors in combination with internal auditors. • The audit committee should consider whether or not an interim report should be subject to an independent external audit review. • At the interim stage, companies should review their previous assessment of the company as a going concern. • The guidelines for the appointment of the audit committee should be strictly interpreted.	• Section 30 (sec. 274A (1)) state that the same individual may not serve as the auditor or designated auditor of a widely held company for more than five consecutive financial years. • Section 30 (sec. 274A (2)) further state that where an individual has served as the auditor or designated auditor of a widely held company for two or more consecutive financial years and then ceases to be the auditor or designated auditor, the individual may not be appointed again as the auditor or designated auditor of that company until after the expiry of at least two further financial years. • Section 32 (sec. 275A (1)) state that an auditor appointed to a widely held company may not for the duration of the appointment perform for that company services prohibited under the code of professional conduct mentioned in section 21 (2)(a) of the Auditing Profession Act, (Act No. 26 of 2005). • Section 32 (sec. 275A (2)) state that the Independent Regulatory Board for Auditors shall in the code mentioned in section 32 (sec. 275A (1)) define and prohibit the provision by an auditor of certain non-audit services in circumstances in which these will be subject to the auditor's own auditing. • Section 27 (sec. 271(4)) states that in case of a widely held company with an audit committee, an appointment by directors of the auditor shall only be valid if the audit committee is satisfied that the auditor is independent of the company. • Section 45 (sec. 300A (1)) requires the designated auditor to meet with the audit committee of a widely held
• Selection of external auditors	Functions of the board of directors, auditors' selection, external auditors, selection, external auditors' selection, external auditors' appointment, appointment of external auditor.		
• Audit report	Audit findings, audit, certified audit report, audit independence, qualified audit report, unqualified audit report, uncertified audit report, audited financial statements, un-audited		

	financial statements.		company not more than one month before the board meets to approve the financial statement of the company for any year as to consider matters which appears to the auditor or the audit committee to be of importance and relevance to the proposed financial statements and to the general affairs of the company. • Section 45 (sec. 300A (2)) requires the designated auditor to attend every annual general meeting of a widely held company to respond to any question relevant to the audit of the financial statements. • Section 45 (sec. 300A (3) (a) (b) (c)) makes provision if the designated auditor is unable to attend the annual general meeting of a widely held company.

6. Relation and communication with company shareholders			
Number of categories majored (sub-categories)	***Key word/s***	***King II requirement***	***Corporate Laws Amendment Act, 2006 requirement***
• Shareholders participation thus voting powers	Shareholders, shareholders participation, shareholders voting, shareholders power, shareholders influence, shareholders authority, shareholders control, shareholders involvement, shareholders interest, minority shareholders, majority shareholders.	• Companies should encourage more active participation by shareholders in the affairs of the company and should be prepared to engage institutional investors in discussion of relevant issues. • Shareholders should be encouraged to attend all relevant company meetings. • It is the board's duty to present a balanced and understandable assessment of the company's position in the reporting to stakeholders. Reports should be made in the context of the need for greater transparency and accountability, and should be comprehensive and objective. • Where appropriate, reports should urge institutional shareholders in particular to play a more active role in ensuring that good governance practice is adhered to.	• The Corporate Laws Amendment Act, 2006 did not address shareholders participation, duties and powers per se, although the change to section 21 impact on the shareholders powers and participation. • Section 21 (sec. 228 (2)) requires that if in relation to the consolidated financial statements of a holding company, a disposal by any of its subsidiaries would constitute a disposal by the holding company of the whole or the greater part of the undertaking of the company or the whole or the greater part of the assets of the company that such disposal requires a special resolution of the shareholders of the holding company.
• Shareholders duties and powers	Shareholders duties and powers, shareholders duties, shareholders power, shareholders influence, shareholders authority, shareholders control, shareholders involvement, shareholders interest, minority shareholders, shareholders responsibility, majority shareholders, shareholders function, shareholders task.		

7. Company's code of ethics			
Number of categories majored (sub-categories)	***Key word/s***	***King II requirement***	***Corporate Laws Amendment Act, 2006 requirement***
• Code of ethics	Ethics, moral, integrity, beliefs, principles, moral principles, moral values and moral code.	• A company should implement its code of ethics as part of corporate governance. • A code of ethics should: commit the company to the highest standard of behaviour, be developed in such a way as to involve all stakeholders, receive total commitment from the board and the CEO of a company; and be sufficiently detailed to give clear guidance as to the expected behaviour of all employees in the company.	• The Corporate Laws Amendment Act, 2006 did not pronounce on the matters relating to the company's code of ethics.
• Whistle blowing	Whistle blowing, whistle blowing programme, tips to the CEO, report fraud, fraud hotline, fraud email, fraud communication, and whistle blowers.		

APPENDIX D – FTSE GLOBAL CLASSIFICATION SYSTEM

Super-sector	**Description**
Oil & Gas	Covers companies engaged in the exploration, production and distribution of oil and gas, and suppliers of equipment and services to the industry.
Chemicals	Encompasses companies that produce and distribute both commodity and finished chemical products.
Basic Resources	Comprises companies involved in the extraction and basic processing of natural resources other than oil and gas, for example coal, metal ore (including the production of basic aluminium, iron and steel products), precious metals and gemstones, and the forestry and paper industry.
Construction & Materials	Includes companies engaged in the construction of buildings and infrastructure, and the producers of materials and services used by this sector.
Industrial Goods & Services	Contains companies involved in the manufacturing industries and companies services servicing those companies. Includes engineering, aerospace and defence, containers and packaging companies, electrical equipment manufacturers and commercial transport and support services.
Automobiles & Parts	Covers companies involved in the manufacture of cars, tyres and new or replacement parts. Excludes vehicles used for commercial or recreational purposes.
Food & Beverages	Encompasses those companies involved in the food industry, from crop growing and livestock farming to production and packing. Includes companies manufacturing and distributing beverages, both alcoholic and non-alcoholic, but excludes retailers.
Personal & Household Goods	Companies engaged in the production of durable and non-durable personal and goods household products, including furnishings, clothing, home electrical goods, recreational and tobacco products.
Health Care	Includes companies involved in the provision of healthcare, pharmaceuticals, medical equipment and medical supplies.
Retail	Comprises companies that retail consumer goods and services including food and drugs.
Media	Companies that produce TV, radio, films, broadcasting and entertainment. These include media agencies and both print and electronic publishing.
Travel & Leisure	Encompasses companies providing leisure services, including hotels, theme parks, restaurants, bars, cinemas and consumer travel services such as airlines and auto rentals.

Telecommunications	Includes providers of fixed-line and mobile telephone services. Excludes manufacturers and suppliers of telecommunications equipment.
Utilities	Covers companies that provide electricity, gas and water services.
Banks	Contains banks whose business is primarily retail.
Insurance	Encompasses companies who offer insurance, life insurance or reinsurance, including brokers or agents
Financial Services	Comprises companies involved in corporate banking and investment services, including real estate activities.
Technology	Companies providing computer and telecommunications hardware and related equipment and software and related services, including internet access.

Source: JSE (2004) - *Advance notice of a change to the FTSE Global Classification System.*

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